Office-Supreme Court, U.S.
FILED
JUL 19 1982
ALEXANDER L. STEVAS,
CLERK

82-106
No.

IN THE
Supreme Court of the United States
OCTOBER TERM, 1981

GLEN CORPORATION, *et al.*,
Petitioners,
v.
O.C. ASSOCIATES, *et al.*,
Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

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July 19, 1982

QUESTIONS PRESENTED

1. Where the right to payment of interest on interest is barred by governing state law regardless of the debtor's solvency, is there an overriding "general rule of federal bankruptcy law" creating a right to payment of such interest in bankruptcy if the debtor proves solvent.

2. Even if there is such a "general rule of federal bankruptcy law," does that rule require the payment of post-petition interest on each unpaid installment of interest that becomes due during a bankruptcy proceeding.*

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* The following were parties to the appeals below: Glen Corporation, Monte J. Wallace, Neil W. Wallace, Paul Lazzaro (Trustee of Continental Investment Corporation), Minority Stockholders' Committee of Continental Investment Corporation (appellees); O.C. Associates, Debentureholders Protective Committee of Continental Investment Corporation, The First National Bank of Boston, as Indenture Trustee, and Bankers Trust Company, as Indenture Trustee (appellants). Glen Corporation has no partially-owned subsidiaries or affiliates. Global Investments Limited Partnership owns the preferred shares of Glen Corporation. Global Investment Limited Partnership has one partially-owned subsidiary, ConVest Energy Corporation.

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

Glen Corporation, Monte J. Wallace, and Neil W. Wallace (the majority shareholders of Continental Investment Corporation), and the Minority Stockholders' Committee of Continental Investment Corporation, respectfully petition for a writ of certiorari to the United States Court of Appeals for the First Circuit to review that court's judgment of April 30, 1982, in *O.C. Associates v. Continental Investment Corp.*, No. 81-1743; *Debentureholders Protective Comm. of Continental Investment Corp. v. Continental Investment Corp.*, No. 81-1741; and *Bankers Trust Co., Indenture Trustee v. Continental Investment Corp.*, No. 81-1756.[1]

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[1] Review has not been sought with respect to a fourth related case, *First National Bank of Boston, Indenture Trustee v. Continental Investment Corp.*, No. 81-1742. *See* note 4 *infra*.

OPINIONS BELOW

The opinion of the court of appeals is not yet officially reported and appears as Appendix A to this Petition. The order of the district court from which appeal was taken and the district court's Memorandum Opinion, which is also unreported, appear as Appendix B.

JURISDICTION

The judgment of the court of appeals was entered on April 30, 1982. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1) (1976).

STATUTES INVOLVED

This case involves Sections 63a and 221(2) of the former Bankruptcy Act, 11 U.S.C. §§ 103(a), 621(2) (1976).

STATEMENT OF THE CASE

This appeal involves the relationship between federal bankruptcy law and the laws of numerous states that govern contracts providing for the payment of interest. The contract at issue in this appeal was governed by New York law, which explicitly bars enforcement of agreements to pay interest on unpaid installments of interest not already due at the effective date of the agreement. Despite finding that New York law barred the payment of such interest, the court of appeals ordered the award of interest on both pre-petition and post-petition unpaid installments of interest, basing its order on an overriding "general rule of federal bankruptcy law."

This case arises out of the reorganization under Chapter X of the Bankruptcy Act ("the Act") of Continental Investment Corporation ("CIC").[2] In October 1970 CIC

[2] The initial petition for arrangement under Chapter XI was filed in April 1976. On November 6, 1978, Congress enacted the Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549, which provided that a new Bankruptcy Code would apply to cases

issued 9 percent per annum convertible subordinated debentures in the aggregate face amount of $30 million due on November 1, 1990. In April 1973, CIC offered a new issue of straight debentures, due on November 1, 1985, in exchange for the outstanding convertible debentures. The straight debentures also bore interest at 9 percent per annum. The holders of the convertible debentures were initially offered a 30 percent premium, $1,300 principal amount of straight debentures for each $1,000 principal amount of convertible debentures; this premium was later increased to 40 percent, and most, but not all, of the convertible debentures were exchanged for the straight debentures.

The provisions of the indentures that gave rise to this appeal provided that different state laws would govern the respective debenture issues. The indentures for both issues provided that, in the event of default, the principal and any then-unpaid installments of interest would become due upon demand. They also provided that while interest would be paid on the principal, interest on any unpaid installments of interest would be due only "to the extent permitted by law." But by explicit provision in the indentures, the "law" governing the 1970 convertible debentures "for all purposes" was the law of Massachusetts; that governing the 1973 straight debentures "for all purposes" was the law of New York. *See* App. A at 3a-4a; Court of Appeals' Joint Appendix ("J.A.") at 256, 353.

Both indentures provided for semi-annual payments of installments of interest, with the principal due in a lump sum on the maturity dates. CIC failed to pay the installments of interest due on both issues of debentures on November 1, 1974, and thereafter failed to make any interest payments. Both indentures permitted the in-

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commenced on or after October 1, 1979. As discussed in Section IV below, the issues raised by this appeal apply both to the many cases currently pending under the Bankruptcy Act and to cases filed under the new Bankruptcy Code.

denture trustee to demand immediate payment of the full amount of principal and all accrued and unpaid interest following such a default. (J.A. 214-15, 311.) Notwithstanding these provisions, neither trustee demanded payment or commenced suit to collect any amount owing thereon, so neither issue of debentures was accelerated. A year and a half later, on April 30, 1976, CIC filed its petition for arrangement under Chapter XI of the Act. That proceeding was converted to a Chapter X reorganization in March 1978.

The reorganization of CIC proved to be a major success, allowing all creditors to be paid in full with the balance to be paid to the shareholders.[3] On June 5, 1981, the trustee for CIC submitted his Third Modified Plan. The plan provided for payment in full, in cash, of each debentureholder's allowed claim. The trustee proposed to pay both the full face amount of the principal of the debentures and all unpaid and accrued installments of interest up to the date of proposed payment, but did not provide for payment of interest on the unpaid installments of interest.

On June 18, 1981, the district court issued a decision approving the trustee's plan but reserving decision concerning the payment of interest on the unpaid installments of interest (J.A. 429); no appeal was taken from that decision or from the district court's order confirming the plan. In an opinion dated September 9, 1981, the district court found that there was good cause to deny payment of the additional amounts representing interest on all unpaid installments of interest. With respect to the small amount of debentures governed by Massachusetts law, the district court found that while Massachusetts law permitted agreements to pay such interest, payment

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[3] There are approximately 4,000 public shareholders of CIC. *See* Opposition of the Minority Shareholders' Committee to Claims of the Debentureholders, filed in the district court, at 4. The shareholders will realize approximately $40 million from the reorganization of CIC. (J.A. 430.)

of the full amount of principal due the debentureholders nine years before the final maturity date satisfied the requirement that the plan be fair and equitable. With respect to the far larger amount of debentures governed by New York law, the district court concluded that because New York law clearly barred any right to interest on unpaid installments of interest, no such payments would be allowed under the plan.

The briefs on appeal to the United States Court of Appeals for the First Circuit made diverse arguments on behalf of the New York (*i.e.*, straight) debentureholders.[4] The Debentureholders Protective Committee argued[5] that the contractual provision for interest on interest was valid under New York law and entitled the debentureholders to interest on all overdue installments of interest, including both those matured at the time of the petition and those maturing post-petition. The Indenture Trustee and O.C. Associates, representing the bulk of the straight debentureholders, abandoned any claim to interest on interest based on state law, arguing instead that federal bankruptcy law entitled the debentureholders to interest on installments of interest already overdue when CIC filed its Chapter XI petition ("interest on pre-petition interest").[6] They made no claim, however, that federal law entitled the debentureholders to interest on installments of interest falling due post-petition ("interest on post-petition interest").

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[4] The convertible debentureholders also appealed and won reversal. Because those debentures were governed by Massachusetts law, which does allow contracts for interest on future unpaid installments of interest, that case is not the subject of this petition.

[5] Brief of Debentureholders Protective Committee at 4-14, in 81-1741.

[6] Brief of Bankers Trust at 8; Brief of O.C. Associates at 21, in 81-1756 and 81-1743, respectively. O.C. Associates, which holds almost 60 percent of the straight debentures, acquired those debentures after the filing of the petition in bankruptcy (J.A. 369-70). The general partners of O.C. Associates are an affiliate of the Charter Company and an affiliate of Oppenheimer & Co. *Id.*

Of the five possible categories of interest arising under these debentures, two (pre-petition and post-petition interest on principal) were not before the court because the debentureholders' entitlement under state law had not been disputed. The court of appeals, in an opinion by Judge Wyzanski, denied a third category (pre-petition interest on unpaid pre-petition interest) as barred by state law and, because pre-bankruptcy, not within any entitlement under bankruptcy law. The court held that the fourth possible category, post-petition interest on unpaid pre-petition interest, was a matter of federal bankruptcy law. The court proceeded to award this interest because it asserted that a "general rule of federal bankruptcy law" established the right to payment of post-petition interest on claims, even though it also held that the debentureholders were not entitled to such interest under governing state law.[7] Finally, the court held that the debentureholders were entitled to post-petition interest on post-petition interest (that is, on interest installments that became due after the debtor filed its petition in bankruptcy). The court based this right not on state law, as had been argued by the one debentureholder rep-

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[7] The court described the contention that New York law permits recovery of interest on interest as "devoid of merit," App. A. at 14a, citing the leading case of *Young v. Hill*, 67 N.Y. 162 (1876), as well as *Newburger-Morris Co. v. Talcott*, 219 N.Y. 505, 510, 114 N.E. 846, 847 (1916) ("The rule is settled that a promise to pay interest upon interest is void if made at a time before simple interest has accrued") (Cardozo, J.); *Giventer v. Arnow*, 37 N.Y.2d 305, 308, 333 N.E.2d 366, 368, 372 N.Y.S.2d 63, 66 (1975) (same); *Vanston Bondholders Protective Comm. v. Green*, 329 U.S. 156, 171-76 (1946) (citing *Talcott* at 510 and lower court's opinion) (Frankfurter, J., concurring); *Empire Trust Co. v. Equitable Office Bldg. Corp.*, 167 F.2d 346, 348-49 (2d Cir. 1948) (promise to pay interest on overdue interest coupons is void under New York law) (Swan, J.). *See also Williamsburgh Savings Bank v. Town of Solon*, 136 N.Y. 465, 481, 32 N.E. 1058, 1062 (1893); *Levine v. U.N. Cleaners*, 4 A.D.2d 954, 167 N.Y.S.2d 801, 802 (App. Div. 1957).

resentative claiming such interest, but rather on overriding federal law.

The court of appeals also held that the absolute priority rule required, in the circumstances of this case, that the plan of reorganization could not award any payments to the shareholders unless it compensated debentureholders for each of the categories of interest payments to which the court found they were entitled. It therefore reversed the district court's decision.

REASONS FOR GRANTING THE WRIT

I. THE COURT OF APPEALS' DECISION THAT A "GENERAL RULE OF FEDERAL BANKRUPTCY LAW" ESTABLISHES A RIGHT TO INTEREST ON INTEREST EVEN WHERE STATE LAW BARS ITS PAYMENT IS CONTRARY TO THE DECISIONS OF THIS COURT AND IMPROPERLY OVERRIDES GOVERNING STATE LAW.

The court of appeals overturned the decisions of the trustee and the district court because it concluded that a plan of reorganization of a solvent debtor could not be "fair and equitable" within the meaning of Section 221 (2) of the Bankruptcy Act if it failed to provide for the payment of post-petition interest on all unpaid pre-petition and post-petition installments of interest. The court concluded that the right to such payment arose from an overriding "general rule of federal bankruptcy law" providing for interest even where there is no right to that interest under governing state law. There is no such "general rule" and none of the cases cited by the court of appeals supports the court's decision. This Court should grant certiorari because the court of appeals' unprecedented decision is contrary to numerous opinions of this Court and improperly intrudes on contractual relations governed by state law.

A. The Cases Relied Upon by the Court of Appeals Clearly Establish That Applicable Non-Bankruptcy Law, Not Bankruptcy Law Itself, Determines Any Right to Post-Petition Interest on Unpaid Installments of Interest.

The court of appeals recognized that this Court has held on a number of occasions that post-petition interest on claims usually is not allowed under federal bankruptcy law. App. A. at 10a. Post-petition interest may be allowed, however, where, as here, the debtor proves solvent. The court of appeals read the cases recognizing this "solvency exception" as supporting an overriding "general rule of federal bankruptcy law" creating a right to payment of interest even where applicable state law bars the payment of interest. The cases cited by the court show, however, that the only general federal rule is that where a debtor proves solvent, bankruptcy courts may enforce a right to interest arising under applicable non-bankruptcy law.

The only opinion of this Court cited by the court of appeals in support of the existence of its "general rule" is *City of New York v. Saper*, 336 U.S. 328 (1949). App. A at 15a. In *Saper* this Court held that post-petition interest would not be allowed on tax claims against a bankrupt because of the "long-standing rule against post-bankruptcy interest. . . ." 336 U.S. at 332. The holding in *Saper* clearly provides no support whatsoever for the decision below.

The court of appeals presumably[9] sought support in this Court's footnote 7 in *Saper*, which said:

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[8] In fact, this Court observed there that "there is no interest except that which accrues according to law, . . ." *id.* at 331-32, and the claim to interest in *Saper* arose not from bankruptcy law, but from federal and state tax law, *id.* at 340 n.18; *Saper v. City of New York*, 168 F.2d 268, 269 (2d Cir. 1948), *aff'd*, 336 U.S. 328 (1949).

[9] The citation of *Saper* as authority for the "general rule" referred to no particular part of that opinion, App. A at 15a; the only citation of *Saper* with a specific reference was to footnote 7, *id.* at 11a.

> "Two exceptions [to the rule against post-bankruptcy interest] were recognized: if the alleged 'bankrupt' proved solvent, creditors received post-bankruptcy interest before any surplus reverted to the debtor, *Bromley v. Goodere*, 1 Atk. 75; *Ex parte Mills*, 2 Ves. Jr. 295; *Ex parte Clark*, 4 Ves. Jr. 676; . . . . These exceptions have been carried over into our system. See *American Iron & Steel Mfg. Co. v. Seaboard Air Line Ry.*, 233 U.S. 261, 267 . . . ."

This footnote, however, stands for nothing more than the proposition that *if* the creditor is otherwise entitled to interest under applicable nonbankruptcy law, *then* the creditor may receive that interest if the debtor turns out to be solvent. It creates no overriding "general rule of federal bankruptcy law" transforming a noninterest-bearing claim into a right to interest, as analysis of the cases this Court cited makes clear.

Bromley v. Goodere, 1 Atk. 75, 26 Eng. Rep. 49 (1743), the leading English case on interest payments in such circumstances, held only that where debts are interest-bearing by a valid explicit contract, creditors of a bankrupt's estate are entitled to post-bankruptcy interest before any surplus reverts to the debtor. *Ex parte Mills*, 2 Ves. Jr. 295, 30 Eng. Rep. 640 (1793), stands for the same proposition (it explicitly approved the decision in *Bromley*) and extends it to implied contracts for interest. And *Ex parte Clark*, 4 Ves. Jr. 677, 31 Eng. Rep. 349 (1799), simply held that one group of creditors was not entitled to be paid interest until after another group of creditors had their claims for principal satisfied.

The relevant Supreme Court opinion cited, *American Iron & Steel Mfg. Co. v. Seaboard Air Line Railway*, 233 U.S. 261 (1914), adopts this English exception, but like the English cases, provides no support for an independent federal right to interest. In fact, that opinion demonstrates that the only "federal rule" is a rule of distribution that permits federal bankruptcy courts in cer-

tain circumstances to allow payment of interest which has been accruing pursuant to a contract valid under state law.[10] The Court explained that the general rule refusing to allow interest after bankruptcy "is not because the claims had lost their interest-bearing quality . . . but is a necessary and enforced rule of distribution . . . ." *Id.* at 266. Since interest continued to run, "in the rare instances where the assets ultimately proved sufficient for the purpose, . . . creditors were entitled to interest accruing after adjudication." *Id.* at 267. In order to determine if there were any "interest accruing" on the claim before it, the Court looked to governing Virginia law and concluded that state law would allow interest on such a claim. *Id.* at 265.

The two other cases cited in the decision below as support for the supposed general federal rule, *see* App. A at 15a, are of no possible relevance.[11]

The court of appeals' decision is also inconsistent with two other lines of bankruptcy cases. One such line consists of those cases that have allowed the payment of post-petition interest when the collateral securing a claim is sufficient to satisfy payment of both the pre-petition claim and post-petition interest. *See Coder v.*

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[10] *Cf.* 3A Collier on Bankruptcy ¶ 63.16 [3] at 1870.1 (14th ed. 1975) ("The rate of interest depends upon the contract and the applicable state law as to usury and the legal rate of interest").

[11] In *United States v. Bass*, 271 F.2d 129 (9th Cir. 1959), the Court of Appeals for the Ninth Circuit held that the United States was not entitled to post-bankruptcy interest on a tax claim supported by a lien prior to the filing of the petition in bankruptcy. This holding is clearly irrelevant, and the opinion below apparently cites *Bass* only because, in passing, the *Bass* court referred, *id.* at 130, to the solvency exception, discussed above. Similarly, *Littleton v. Kincaid*, 179 F.2d 848 (4th Cir.), *cert. denied*, 340 U.S. 809 (1950), provides no support for the decision below, since the issue there was the date to which interest on interest-bearing notes should be allowed, *id.* at 852, and not whether bankruptcy proceedings created an independent right to interest.

Arts, 213 U.S. 223, 245 (1909).[12] This Court's opinions have consistently stated that the nature of the underlying claim determines whether, and at what rate, post-petition interest will be paid on such a secured claim. *See, e.g., Ecker v. Western Pacific Railroad*, 318 U.S. 448, 455 (1943).[13] The court of appeals' decision is also at odds with the federal bankruptcy treatment of claims based on contracts allegedly usurious under state law. Where claims arising under such contracts have been made, the courts have looked to state law to determine whether to allow such claims in bankruptcy and whether, if allowed, they bear interest.[14] This rule led the Second Circuit to hold that where governing state law provided that a mortgagee who had engaged in a usurious transaction could recover only its principal with no payment of interest, bankruptcy law would follow state law and no interest would be allowed. *Speare v. Consolidated Assets Corp.*, 367 F.2d 208 (2d Cir. 1966).[15]

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[12] *See also Palo Alto Mutual Savings & Loan Ass'n v. Williams*, 245 F.2d 77 (9th Cir. 1957); *Eddy v. Prudence Bonds Corp.*, 165 F.2d 157 (2d Cir. 1947), *cert. denied*, 333 U.S. 845 (1948).

[13] In *Ecker*, post-petition interest was paid to secured creditors at the "contract rate" on interest-bearing claims; the highest-ranking creditor of all (the Reconstruction Finance Corporation) received no interest because its Trustee's certificate did not provide for interest. *Id.* at 455. If the right to post-petition interest were indeed a "federal rule," the top-ranking secured creditor would always be entitled to post-petition interest before lower-ranking creditors were paid. Similarly, *Ticonic National Bank v. Sprague*, 303 U.S. 406, 410 (1938), held that where a depositor with a valid lien was otherwise "entitled to interest as damages for the failure to pay that balance upon demand . . . [t]he bank's obligation . . . is not cut off by suspension of its business and receivership." This Court never intimated that the right to interest arose as an incident of the bankruptcy proceeding.

[14] *See* 3A Collier on Bankruptcy, *supra*, ¶ 63.07 [15], at 1822-24.

[15] The mortgagee in *Speare* sought payment of its principal with "legal interest," the debtor having been in bankruptcy for five years. In rejecting the claim to post-petition interest because it would not be allowed under governing state law, the court never

In sum, as both the English and the American cases make clear, in the limited circumstances where post-petition interest may be paid in bankruptcy, the creditor has a right only to such interest as is allowed under applicable state law. Absent a right valid under state law, there is no federal right to receive interest from the estate of a bankrupt, even when the bankrupt proves solvent. Once the court below determined that governing state law barred the claimed payments of interest on unpaid installments of interest, the court's inquiry should have ended. By awarding the debentureholders interest on unpaid interest—something that was barred under governing state law—the court of appeals improperly intruded into an area of the law reserved to the states.

B. This Court's Decisions in Absolute Priority Rule and Other Cases Confirm That There Is No Overriding Federal Right to Post-Petition Interest.

This Court has held on numerous occasions that for a plan of reorganization under Chapter X or similar statutory provisions to be fair and equitable, it must adhere to the absolute priority rule set down by this Court in *Northern Pacific Railway v. Boyd*, 228 U.S. 482 (1913). The rule stands for the proposition that " 'any arrangement of the parties by which the subordinate rights and interests of the stockholders are to be secured at the expense of prior rights' of creditors 'comes within judicial denunciation.' " *Consolidated Rock Prod. Co. v. DuBois*, 312 U.S. 510, 527 (1941). *Accord, Case v. Los Angeles Lumber Prod. Co.*, 308 U.S. 106, 116 (1939).

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hinted that because the creditor had a valid pre-petition claim to its principal, there was an alternative federal right to post-petition interest where barred by state law. *See also Woods-Tucker Leasing Corp. v. Hutcheson-Ingram Dev. Co.*, 626 F.2d 401 (5th Cir. 1980), *modified*, 642 F.2d 744 (5th Cir. 1981) (state usury law the critical determinant of the validity and enforceability of the claim, and of the appropriate remedy).

The debentureholders asserted below that the supposed federal right to post-petition interest arose as an incident of the absolute priority rule.[16] But that rule cannot be the source of any such right. The sole purpose of the absolute priority rule is to rank creditors and equity interests in descending order of priority and to require that before payments are made to holders of lower-level interests, those with superior interests receive full satisfaction of their claims.[17] And the claims which the absolute priority rule requires to be satisfied arise from applicable nonbankruptcy law. As this Court stated in *Vanston Bondholders Protective Committee v. Green*, 329 U.S. 156, 161 (1946):

> "What claims of creditors are valid and subsisting obligations against the bankrupt at the time a petition in bankruptcy is filed is a question which, in the absence of overruling federal law, is to be determined by reference to state law."[18]

The powerful concurring opinion of Justice Frankfurter fully agreed with this analysis.

> "Obligations to be satisfied out of the bankrupt's estate thus arise, if at all, out of tort or contract or other relationship created under applicable law. And

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[16] O.C. Associates maintained in the court of appeals that the "prime issue is whether the [absolute priority] rule" required the payment of post-petition interest on unpaid pre-petition interest. Brief of O.C. Associates at 1-3. *See also* Brief of Bankers Trust at 8; Brief of Debentureholders' Protective Committee at 14.

[17] *See* 6 Collier on Bankruptcy, *supra*, ¶ 9.08, at 1570 (the absolute priority rule requires that creditors receive full compensatory treatment "for the entire bundle of rights they surrender."). If no right to interest on interest exists under applicable law, there is no right to "surrender" and no claim to satisfy under that rule.

[18] The court of appeals pointed to no provision of the Bankruptcy Act or any other statute as indicating that Congress had enacted any "overruling federal law" intended to supplant governing state law. As shown in Section IV *infra*, there are substantial reasons why state law should determine this issue.

> the law that fixes legal consequences to transactions is the law of the several States." *Id.* at 169 (Frankfurter, J., concurring).

The absolute priority rule is a rule of distribution, not a rule that creates substantive rights.[19] The absolute priority rule cases are, however, relevant to the debentureholders' claim here in one crucial respect. Since the absolute priority rule requires the full satisfaction of superior claims, if there were a "general rule of federal bankruptcy law" requiring the payment of post-petition interest, its existence presumably would be reflected in this Court's opinions discussing that rule. The principal cases elucidating the absolute priority rule show, however, that there is no such "general rule." In *Consolidated Rock Products, supra*, the interest awarded to the bondholders was determined not by federal bankruptcy law, but by the terms of their indenture.[20] Most significantly, although interest on the outstanding bonds had been in default for approximately seven years, no provision was made for payment of interest on the accrued and unpaid interest, matured or unmatured.[21] Similarly, in *Ecker v.*

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[19] "[T]he [absolute priority] rule controls the *payment* of allowable interest, not the determination of what interest is allowable." *In re New York, New Haven and Hartford R.R.*, 4 B.R. 758, 799 (D. Conn. 1980) (emphasis in original).

[20] *See* 312 U.S. at 514-15.

[21] The decisions of both the court of appeals and of this Court proceeded on the assumption that those decisions applied whether or not the debtor proved to be solvent. *See* 312 U.S. at 527; 114 F.2d at 107. In that case this Court awarded only simple interest at the contract rate on the outstanding principal. The amount of interest that the Court protected was equal to the number of years between the last payment of interest on the bonds and the effective date of the plan, multiplied by the product of the stated interest rate (6%) and the principal amount of the bonds outstanding. *See* 312 U.S. at 514-15. This demonstrates that the Court applied the absolute priority rule only to simple interest on the principal, with no award of interest on either pre-petition or post-petition accrued and unpaid interest.

Western Pacific Railroad, *supra*, 318 U.S. at 455, the post-petition interest awarded on the allowed claims was computed at the "contract rate." Thus, where the contract underlying the highest-ranking claim did not provide for interest, none was allowed.[22] The plan approved in *Ecker*, therefore, is also inconsistent with the overriding "general rule" found by Judge Wyzanski.[23]

The court of appeals claimed to find support for its "general rule" in this Court's opinion in *Vanston Bondholders Protective Comm. v. Green*, *supra*. App. A at 15a. But *Vanston* could not provide support for any such "rule." Because the debtor in *Vanston* was insolvent, this Court declined to order any post-petition interest on interest, even though provided by contract and even assuming that it were permitted by state law. 329 U.S. at 166-67. In reaching that decision, this Court confirmed that while the decision whether to *allow* interest is a matter of federal law, there is no claim to interest for a federal court to allow or disallow unless it arises under governing state law.

This two-step analysis is clear from this Court's treatment of the claim in *Vanston*. The first step there was disposed of by "assuming, *arguendo*, that the obligation for interest on interest is valid under" state law. 329 U.S. at 162. The second step was necessary, this Court said, because even if the obligation were valid under state law, "we would still have to decide whether *allowance* of the claim would be compatible with the policy of the Bankruptcy Act." *Id.* (emphasis added). As put by Jus-

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[22] In *Ecker*, the Court approved a plan under which no interest at all was allowed on a claim based on a noninterest-bearing Trustee's certificate, even though the claimant, the Reconstruction Finance Corporation, held a lien "on the entire estate." 318 U.S. at 455.

[23] *See* 6 Collier on Bankruptcy, *supra*, ¶ 9.08, at 1570-71 (the interest which accrues is that "fixed by contract or by the applicable local law") (footnote omitted).

tice Frankfurter, "We do not reach considerations of policy in bankruptcy administration until there are rights, created by local applicable law, to be recognized." *Id.* at 171 (concurring opinion).[24]

Thus, there is simply no precedent in the absolute priority rule cases or the other leading opinions of this Court for any such overriding "general rule" permitting or requiring the payment of post-petition interest, or, *a fortiori*, interest on such interest,[25] except where the creditor is entitled to such payments pursuant to a contract valid under state law. The court of appeals' award of interest barred by state law has taken from the shareholders what is theirs by right and improperly given it to the debentureholders.

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[24] *See Northern Pipeline Construction Co. v. Marathon Pipeline Co.*, —— U.S. ——, 50 U.S.L.W. 4892, 4901 n.36 (U.S. June 28, 1982) (plurality opinion) (*adjustment* of rights in bankruptcy is matter of federal law). Even if the right to post-petition interest could be construed as arising under federal law, no federal reason exists for overriding the different laws of the different states. As shown in Section IV.A. *infra*, there are substantial reasons for federal courts to adopt state laws as their rule of decision in this area even if the source of the right is federal law. Such a policy of deference to property interests defined by state law has been followed by this Court in similar contexts. For example, in *United States v. Kimbell Foods, Inc.*, 440 U.S. 715 (1979), this Court considered whether consensual liens arising from federal loan programs took precedence over private liens. While finding that the source of the law was federal, the Court adopted applicable state law for establishing priorities. *Id.* at 718. Expressing great concern about overriding "intricate state laws of general applicability," *id.* at 729, the Court concluded that, "[b]ecause the ultimate consequences of altering settled commercial practices are so difficult to foresee, we hesitate to create new uncertainties, in the absence of careful legislative deliberation." *Id.* at 739-40.

[25] "The general rule . . . is that in the absence of a contract therefor or some statute, compound interest is not allowed to be computed on a debt." *Cherokee Nation v. United States*, 270 U.S. 476, 490 (1926).

II. EVEN IF THERE WERE SUCH A "GENERAL RULE OF FEDERAL BANKRUPTCY LAW," IT WOULD HAVE TO BE LIMITED TO INTEREST ON UNPAID INTEREST INSTALLMENTS THAT BECOME DUE BEFORE THE BANKRUPTCY PROCEEDINGS BEGIN AND WOULD NOT APPLY TO INTEREST ON INTEREST INSTALLMENTS THAT BECOME DUE THEREAFTER.

Even if there were a "general rule of federal bankruptcy law" creating a right to interest on interest, the Bankruptcy Act and the Bankruptcy Code make clear that this rule could not produce a right to interest on installments of interest that did not mature until after the filing of the petition in bankruptcy. In fact, in their appeals to the court of appeals, the bulk of the debentureholders sought post-petition interest on the unpaid *pre-petition* installments of interest only.[26] The court of appeals, however, applied its overriding "general rule" to produce not just the interest that these debentureholders sought, but also post-petition interest on each installment of interest that came due *during* the bankruptcy proceedings. The court did this by reading the proofs of claim filed in April 1976 to include claims for each post-petition installment of interest, even though those installments were not then due, and awarding interest on each of those installments from the date that it came due. "General rule" or no "general rule," what the court of appeals did in creating a right to interest on installments of interest that matured *during* the reorganization proceeding is simply wrong.[27]

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[26] Post-petition simple interest on principal, accruing pursuant to state law, was provided by the plan and was never at issue.

[27] Because entitlement to post-petition simple interest is unquestioned, the court's inclusion of post-petition installments of interest on the principal *in* the claim, rather than treating them as interest *on* a claim to the principal, may at first seem an unimportant technicality. However technical, this error more than doubled the stakes here. By producing post-petition interest on post-petition interest, it increased the amount at issue from approximately $3 million

There are at least three separate grounds for rejecting this portion of the lower court's opinion. First, the proof of claim itself did not include a claim for the unmatured installments of interest that were not owing at the time of the filing of the petition. The proof of claim was quite explicit and consisted of a claim for the principal and for the "interest due and unpaid as of April 30, 1976," the date of the filing of the petition. J.A. 363-65.[28] Second, the court's treatment misreads the Bankruptcy Act, which specifically limits allowance of claims based on a fixed liability to those "absolutely owing at the time of the filing of the petition . . ., with any interest thereon which would have been recoverable at that date . . . ." Section 63a(1), 11 U.S.C. § 103(a)(1) (1976). The post-petition installments of interest certainly were not recoverable at the time of the filing of the petition and thus were not an allowable claim.[29] The new Bankruptcy Code supports

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(App. A at 6a-7a) to an amount calculated by counsel to the Trustee to be approximately $6.6 million for the straight debentures alone.

[28] The court of appeals conceded that it could find post-petition interest to be included in the proof of claim only by engaging in a "liberal interpretation" of the language of the proof of claim. App. A at 13a n.5, 16a. O.C. Associates, holding a majority of the straight debentures, did not even claim a right to interest on the post-petition installments of interest in its brief on appeal, Brief of O.C. Associates at 5-6, nor did Bankers Trust, the indenture trustee. Brief of Bankers Trust at 6. Only the Debentureholders' Protective Committee made any claim to such interest payments. It based its claim on state law, a basis clearly rejected by the court of appeals, (App. A at 14a-15a), and on the absolute priority rule, which cannot be the source of any such right, *see* pp. 13-15 *supra*.

[29] *See In re Oklahoma Ry.*, 61 F. Supp. 96 (W.D. Okla. 1945). Not even in the case of judgments obtained post-petition and incorporating interest is interest accruing between the petition and the judgment allowable. Act, § 63a(5). Nor can unmatured interest be allowed as within Section 63a(8), covering "contingent debts and contingent contractual liabilities." To hold otherwise would render the bar to unmatured interest in Sections 63a(1) and 63a(5) a nullity. Moreover, New York's highest court has said that "[u]nearned interest to become due in the future is not a debt." *Continental Securities Co. v. New York Central & Hudson River R.R.*,

this conclusion by specifically providing that a court shall disallow a claim to the extent it is for "unmatured interest." 11 U.S.C. § 502(b)(2) (Supp. III 1979).[30] Finally, the court of appeals did not cite a single case supporting its award of interest on unmatured interest, and its decision is contrary to the decisions of this and other courts.[31]

The extension by the court of appeals of its "general rule" to require not only the payment of interest on unpaid pre-petition interest but also the payment of interest

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217 N.Y. 119, 111 N.E. 484, 486 (1916) (Cardozo, J.). *Cf. In re Tastyeast, Inc.*, 126 F.2d 879 (3d Cir.), *cert. denied*, 316 U.S. 696 (1942) (where a note provided for post-maturity increased interest, note matured post-petition, and debtor erroneously believed contingent obligations not provable and allowable, the court accepted debtor's argument that it was a contingent obligation but held it unenforceable as a penalty).

Section 106(1) of the Act, 11 U.S.C. § 506(1), which defines Chapter X claims to include claims not "provable under section 63," leads to no different result. Since the unmatured interest was not a debt owed at the time the petition was filed, its inclusion in a proof of claim would have been disallowed under Section 196, 11 U.S.C. § 596, on the ground that there was "no valid claim." *See* 6 Collier on Bankruptcy, *supra*, ¶ 9.05, at 1544 (footnote omitted).

[30] Although the provisions of the Code do not apply to this case, *see* Bankruptcy Reform Act of 1978 § 403(a), 11 U.S.C. prec. 101 (Supp. II 1978), the legislative history of the Code clearly states that Congress understood the Code treatment of unmatured interest as simply codifying existing law: "Section 502(b) . . . contains two principles of present law. First, interest stops accruing at the date of the filing of the petition, because any claim for unmatured interest is disallowed under this paragraph." H.R. Rep. No. 95-595, 95th Cong., 1st Sess. 353 (1977).

[31] *See, e.g., Consolidated Rock Prod. v. Du Bois, supra*; *Ecker v. Western Pacific Railroad, supra*; *Empire Trust Co. v. Equitable Office Building Corp.*, 167 F.2d 346 (2d Cir. 1948) (discussed in note 33 *infra*). *See also American Iron & Steel Mfg. Co. v. Seaboard Air Line Ry., supra*, at 265 (question certified: "Is interest recoverable *on* such a claim for the period of the receivership?") (emphasis added); *Group of Institutional Investors v. Chicago, Milwaukee, St. Paul & Pacific R.R.*, 318 U.S. 523, 535 n.7 (1943) (claims include principal and pre-petition interest; interest on claims considered separately).

on each installment of interest falling due during the bankruptcy proceeding demonstrates the far-reaching impact of its opinion. This Court should grant certiorari to review this unprecedented and significant decision.

III. THE COURT OF APPEALS' DECISION CONFLICTS WITH THIS COURT'S HOLDING IN *BUTNER* v. *UNITED STATES* AND WITH TWO DECISIONS OF THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT.

A. *Butner* v. *United States* Establishes That the Bankruptcy Laws Look to State Law in Determining the Validity of Post-Petition Claims.

The court of appeals conceded that pre-petition "interest is governed by state law, absent an overruling federal law." App. A at 8a. When it came to post-petition interest, however, the court stated that "federal not state law determines in a bankruptcy case whether a creditor is entitled to post-petition interest on a valid pre-petition claim." *Id.* at 15a.

In making this distinction, the court of appeals apparently believed that claims based on facts existing *after* the date of the filing of the petition were to be governed by federal law. In reaching this conclusion, the court below totally ignored this Court's recent decision in *Butner v. United States*, 440 U.S. 48 (1979).[22] *Butner* also concerned an alleged "federal rule" allowing post-petition claims nonexistent under applicable state law. A mortgagee there claimed a right to recover rents collected after the petition in bankruptcy was filed, even though under state law he was not entitled to the rents because he had not foreclosed on the property. The courts of appeals had split on the issue, with five courts holding that an award could only be made if state law permitted,

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[22] Petitioners explicitly brought *Butner* to the court's attention. *See* Brief for Appellees Glen Corporation, M. Wallace, N. Wallace, Minority Stockholders Committee, at 16-18; *cf.* Reply Brief of O.C. Associates, at 6-7.

and two courts holding that federal bankruptcy law alone governed such post-petition claims. *Id.* at 52-53.

This Court, in an opinion by Justice Stevens, unanimously rejected the holding of the two courts of appeals that had "adopted a federal rule of equity" giving a mortgagee a secured interest in post-petition rents "even if state law would not recognize any such interest until after foreclosure." *Id.* at 53 (footnote omitted). This Court rejected that approach because, "at least in some circumstances, [it] affords the mortgagee rights that are not his as a matter of state law. The rule we adopt avoids this inequity because it looks to state law to define the security interest of the mortgagee." *Id.* at 56. The Court held that state law would determine the mortgagee's rights and affirmed the lower court's decision that barred the creditor's claim because it was not valid under applicable state law.

Petitioners argued below that the claims of the creditor in *Butner* are indistinguishable from the claims made by the debentureholders here. The vast majority of the debentureholders abandoned any claim under state law and, like the mortgagee in *Butner*, relied entirely on an alleged federal right; the same is true of the court of appeals itself, which found no right arising under state law. The failure of the court of appeals even to mention, let alone distinguish, *Butner* clearly indicates the need for this Court to reinforce its holding in that case.

B. The Second Circuit Has Twice Rejected the Same Claims That Were Upheld By the Court of Appeals Here.

The decision below is flatly contrary to two decisions of the United States Court of Appeals for the Second Circuit, which firmly rejected the award in Chapter X proceedings of interest on overdue interest payments where barred by governing state law. This Court should grant certiorari in order to resolve this clear conflict between circuits.

This issue was first presented to the Second Circuit in *In re Realty Associates Securities Corp.*, 163 F.2d 387 (2d Cir.), *cert. denied*, 332 U.S. 836 (1947). The creditors there sought payment of interest from a solvent debtor on the portion of their claim which represented unpaid pre-petition interest. Like the creditors here, they did not rely on any express contract claim to such interest since their indenture made no provision for interest on interest. The court in *Realty* found that interest on unpaid interest was not payable under New York law and, rejecting various equitable theories also put forward by the creditors, denied their claim.

This issue was again presented to the Second Circuit approximately one year later in *Empire Trust Co. v. Equitable Office Building Corp.*, 167 F.2d 346 (2d Cir. 1948). In an opinion by Judge Swan (Judges L. Hand and Frank concurring), the court considered a claim in bankruptcy seeking payment from a solvent debtor of interest on outstanding overdue and unpaid interest coupons. After a careful study, the court determined that the claim was not valid under applicable New York law. That determination ended its review of the claim, the court said, "since we have already decided that the promise to pay interest on interest created no valid obligation to holders of unnegotiated coupons." *Id.* at 349.[33]

Thus, the Second Circuit holds that the allowance of a claim for interest on interest is to be considered in reor-

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[33] *Empire Trust* is also inconsistent with the ruling of the Court below that interest must be paid on each post-petition installment of interest. Even though the debtor there had failed to pay six years of semi-annual interest payments, no interest was paid on the unpaid post-petition installments of interest. Both *Realty Associates* and *Empire Trust* were recently discussed and distinguished by the Second Circuit in *Corbin v. Federal Reserve Bank*, 629 F.2d 233, 237-38 (2d Cir. 1980), *cert. denied*, 450 U.S. 970 (1981); *cf. Ruskin v. Griffiths*, 269 F.2d 827, 830 (2d Cir. 1959), *cert. denied*, 361 U.S. 947 (1960) (distinguishing *Empire Trust* and upholding variable interest rate provision against solvent debtor where valid under state law).

ganization only if it is valid under state law.[34] The First Circuit holds that such a claim, invalid under state law, can be allowed under an overriding "general rule of federal bankruptcy law." This Court should grant certiorari to resolve this conflict between the circuits.

IV. THE CREATION OF A "GENERAL RULE OF FEDERAL BANKRUPTCY LAW" IMPROPERLY INFRINGES ON STATE COMMERCIAL LAW AND WILL ENCOURAGE THE FILING OF ADDITIONAL BANKRUPTCY CASES.

A. This Court and Other Courts Have Repeatedly Held That Bankruptcy Law Will Recognize State Laws Governing Commercial Transactions.

As this Court recently noted, while "Congress has power to enact bankruptcy laws that are uniform throughout the United States," a uniform bankruptcy law "'may recognize the laws of the State in certain particulars, although such recognition may lead to different results in different States.'" *Railway Labor Executives' Association v. Gibbons*, — U.S. —, 102 S. Ct. 1169, 1176 (1982) (*quoting Stellwagen v. Clum*, 245 U.S. 605, 613 (1918)). Thus, "uniformity does not require the elimination of any

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[34] *Accord, In re Georgia, Florida, and Alabama R.R.*, 88 F. Supp. 796 (M.D.Ga. 1950) (New York law; provision void, and per *Vanston*, would not be allowed if valid). *See also In re International Hydro-Electric System*, 32 S.E.C. 504, 512 (1951) (noncontractual claim for interest on interest on interest not enforceable under Massachusetts law; claim denied); this issue was not raised on appeal to the district court, *see In re International Hydro-Electric System*, 101 F. Supp. 222, 225 (D. Mass. 1951). The Second Circuit's approach was also employed by the district court in *In re Norcor Mfg. Co.*, 36 F. Supp. 978 (E.D. Wis. 1941). The court there considered a claim for interest on an interest claim that a master had allowed in an earlier state receivership proceeding. The court noted that the underlying contract did not provide for such interest, found that there "is no statutory authority for allowing compound interest on claims that are allowed in bankruptcy," and concluded that "all that the creditor is entitled to is the face of his claim, plus accrued interest . . . ." *Id.* at 980.

differences among the States in their laws governing commercial transactions." 102 S. Ct. at 1176.

Congress has recognized these "differences among the States" by providing that "no obligation finds its way into a bankruptcy court unless, by the law of the State where the acts constituting a transaction occur, the legal consequence of such a transaction is an obligation to pay," *Vanston Bondholders Protective Committee v. Green*, 329 U.S. 156, 170 (1946) (Frankfurter, J., concurring).[35] This is merely one aspect of the more sweeping policy under which "Congress has generally left the determination of property rights in the assets of a bankrupt's estate to state law," *Butner v. United States*, 440 U.S. 48, 54 (1979). As this Court stated in *Butner:*

> "Property interests are created and defined by state law. Unless some federal interest requires a different result, there is no reason why such interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding. Uniform treatment of property interests by both state and federal courts within a State serves to reduce uncertainty, to discourage forum shopping, and to prevent a party from receiving 'a windfall merely by reason of the happenstance of bankruptcy.' *Lewis*

[35] The differences among the states recognized by this Court in *Butner* and *Railway Labor Executives* have been respected in analogous situations where the payment of interest has been at issue. For example, the Miller Act, 40 U.S.C. §§ 270a-d (1976), provides a cause of action, in lieu of state statutory mechanics' liens, for subcontractors on federal government construction projects. While the allowance of prejudgment interest has been held to be a matter of federal law, the Fifth Circuit looked to state law " 'as a matter of convenience and practicality' " in deciding whether it would be awarded in that case. *United States ex rel. Georgia Electric Supply Co. v. United States Fidelity & Guaranty Co.*, 656 F.2d 993, 996-98 (5th Cir. 1981). And under the federal interpleader statute, 28 U.S.C. § 1335 (1976), it has been held that where governing state law did not permit the award of prejudgment interest, none would be awarded by the federal courts. *Perkins State Bank v. Connolly*, 632 F.2d 1306, 1319-20 (5th Cir. 1980).

v. Manufacturers National Bank, 364 U.S. 603, 609." 440 U.S. at 55.

The court's decision has significant implications for state commercial relations. A number of states either totally disallow the payment of interest on unpaid interest or permit such payments only if expressly provided for by contract.[36] These laws reflect the states' concern about the effect that compound interest can have on even relatively small claims. All of these laws are rendered meaningless after bankruptcy by the court's decision creating a federal right overriding them. The same is true of the many state laws which bar creditors with usurious contracts from collecting interest on those contracts; if there is a federal right to interest, those creditors could collect post-petition interest barred by state law.[37] But there

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[36] Georgia: *Grant v. Fourth Nat'l Bank of Columbus*, 229 Ga. 855, 194 S.E.2d 913, 919 (1972). Idaho: Idaho Code § 28-22-106 (1948). Missouri: Mo. Ann. Stat. § 408.080 (Vernon 1953); *Sloan v. Paris*, 541 S.W.2d 316, 321 (Mo. Ct. App. 1976). Nebraska: *Abbott v. Abbott*, 188 Neb. 61, 195 N.W.2d 204, 209 (1972). New Jersey: *Abramowitz v. Washington Cemetery Ass'n*, 139 N.J.Eq. 293, 51 A.2d 461, 463 (N.J. Ch. 1947). New Mexico: *Southern Union Exploration Co. v. Wynn Exploration Co.*, 95 N.M. 594, 624 P.2d 536, 543 (Ct. App.), *cert. denied*, 95 N.M. 593, 624 P.2d 535 (1981), *cert. denied*, —— U.S. ——, 102 S.Ct. 1276 (1982). Pennsylvania: *Murray v. Prudential Ins. Co.*, 144 Pa. Super. 178, 18 A.2d 820 (1941); *Powell v. Retirement Bd.*, 431 Pa. 396, 246 A.2d 110 (1968). Washington: *Goodwin v. Northwestern Mut. Life Ins. Co.*, 196 Wash. 391, 83 P.2d 231, 238 (1938).

[37] At least eleven states bar creditors holding usurious contracts from collecting interest on their debt, although permitting the creditors to recover their principal. *E.g.*, Ala. Code § 8-8-12 (1975); D.C. Code Ann. § 28-3303 (1981); Fla. Stat. Ann. § 687.04 (West 1966 & Supp. 1982); Ga. Code Ann. § 57-112 (1977); Iowa Code Ann. § 535.5 (West 1950); La. Rev. Stat. Ann. § 9:3501 (West 1951 & Supp. 1981); Mich. Stat. Ann. § 19.15(2) (Callaghan 1981); Miss. Code Ann. § 75-17-1 (1972 & Supp. 1981); Neb. Rev. Stat. § 45-105 (1978); N.J. Stat. Ann. §§ 31: 1-3, 31: 1-4 (West 1963 & Supp. 1981); Va. Code § 6.1-330.45 (1979 & Supp. 1982). Those creditors would have a "claim" in bankruptcy for their principal, on which the court of appeals' decision apparently would award inter-

is no reason underlying the bankruptcy laws that justifies overriding state policy simply because a borrower voluntarily or involuntarily ends up in bankruptcy proceedings. The decision of the court below achieves just the result this Court intended to prevent—" 'a windfall merely by reason of the happenstance of bankruptcy.' "

B. The Court of Appeals' Decision Will Encourage Creditors to Improve Their Positions by Resort to the Bankruptcy Courts Under the New Bankruptcy Code.

The lower court's opinion invites creditors to use the bankruptcy courts to improve their private contractual rights. This case illustrates the point. Under the exchange offer, most of the convertible debentures were traded for straight debentures, at a 30 or 40 percent premium. The convertible debentures provided that they would be governed by Massachusetts law, which allows interest on interest, while the straight debentures were explicitly governed by New York law, which does not. Nearly 60 percent of the straight debentures, in fact, are held by O.C. Associates, which acquired all its debentures *after* the Chapter X filing and *after* the default on the pre-petition interest (J.A. 369-70), presumably paying a price reflecting the effect that New York law would have on any recovery. While the court of appeals recognized the difference in the law governing the two debentures, it reached the same result despite that difference. App. A at 15a-16a.[38]

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est that could not be collected in state court. Yet, as the Fifth Circuit has stated in invalidating a claim because it was usurious under state law, "the determination of whether usury prevents enforcement of the claim should not vary depending upon whether the defense is raised in a state or instead a federal court of the forum [state]." *Woods-Tucker Leasing Corp. v. Hutcheson-Ingram Dev. Co., supra*, 642 F.2d at [illegible] n.8.

[38] The convertible debentureholders argued, in fact, that the payment of a 30 to 40 percent premium to the straight debentureholders was a sufficient reason to treat the two debentures differently on this issue. Brief of First National Bank of Boston at 5 n.

There is no policy in the bankruptcy laws for failing to recognize such differences.[39] As the Second Circuit recently stated in enforcing contract clauses, valid under state law, that permitted creditors to recover collection costs and liquidated damages, bankruptcy law should recognize "the bargained-for terms of the loan contract." *United Merchants & Manufacturers v. Equitable Life Assurance Society*, 674 F.2d 134, 137 (2d Cir. 1982).

If creditors can improve the explicit terms of their loan contracts by resort to a bankruptcy court, they have an incentive to bring bankruptcy proceedings instead of relying on negotiated arrangements. At a minimum, the court of appeals offers an incentive to a creditor whose contract does not provide for interest on interest to start bankruptcy proceedings if the debtor is likely to prove solvent or the creditor's collateral is sufficient to cover payment of interest on interest. The same applies to creditors under contracts for usurious interest where state law bars the recovery of any interest under such a contract. Beyond this, the court of appeals' decision may also provide an incentive to start bankruptcy proceedings to creditors whose contractual rate of interest is below the "statutory general rate," App. A at 15a, wholly apart from any question of interest on interest. This possibility arises because the decision suggests that creditors may rely *either* on their contracts *or* on their supposed federal right to interest, at their election.[40] The bankruptcy

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[39] The equitable powers of a bankruptcy court to, *e.g.*, subordinate claims are unquestioned, but are not relevant here. The court of appeals did not purport to rearrange rights on equitable grounds. Rather, it purported to find claims based on federal law. Only after finding those claims did it address the equitable question of whether those claims must be paid.

[40] The decision nowhere says whether contractual provisions bar resort to the supposed federal right. However, the indenture governing the straight debentures provided for interest on interest "to the extent permitted by law," § 7.02 of the 1973 Indenture (J.A. 311), *quoted in* App. A at 4a-5a; since New York law did not allow any interest on interest, the contractual rate for interest on inter-

court could thus become a board of contract relief for creditors whenever their contract rates are below the legal rate.

The court of appeals' decision would appear to apply not only to the former Bankruptcy Act but also to the new Bankruptcy Code. Section 506(b) of the Code, 11 U.S.C. § 506(b) (Supp. III 1979), embodies the traditional rule that if the value of the security is sufficient, secured creditors receive interest. It provides simply for "interest on such [allowed secured] claim . . . ." [41] While this Court's opinions have limited secured creditors to their contractual interest rate in such circumstances,[42] the court of appeals' decision would appear to give creditors a choice between their contract rate and the rate under the "general rule," whichever is higher. If the contract provides for interest on interest and that provision is invalid under state law, the creditor would also appear to have a right to receive interest on interest as a matter of federal law, just as the straight debentureholders were awarded such a right here.[43] And if the approach

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est was, in effect, zero percent. Most of the straight debentureholders chose not to rely on their contract in claiming interest on interest, and the court permitted them (as well as the straight debentureholders who did rely on their contract) to recover interest on interest at the noncontractual rate of 8 percent. Thus, the court permitted the creditors to choose between federal and state law.

[41] This subsection reads in full:

> "(b) To the extent that an allowed secured claim is secured by property the value of which, after any recovery under subsection (c) of this section, is greater than the amount of such claim, there shall be allowed to the holder of such claim, interest on such claim, and any reasonable fees, costs, or charges provided under the agreement under which such claim arose."

[42] *See* pp. 10-11 above.

[43] That portion of the court's decision awarding interest on each installment of interest maturing during the bankruptcy proceeding would also appear to apply to claims arising under the new Bankruptcy Code, with the same significant consequences as it had in this case. *See* note 27 *supra*.

taken by the court of appeals controls, then secured creditors with sufficient security could improve their positions in bankruptcy proceedings under the Code, precisely as the court of appeals' decision allows under the Act, and directly contrary to this Court's decisions in cases like *Butner*.[44]

Bankruptcy courts have more than enough work without taking on the burden of undoing contracts that contain interest rates below today's elevated legal rates, or lack interest on interest provisions valid under state law, or contain interest rates usurious under governing state law. A federal right to post-petition interest, or to interest on interest, invites creditors to seek to persuade bankruptcy courts to rewrite many of these contracts, whether under the old Act or the new Code. This Court should grant certiorari to prevent such an intrusion of the bankruptcy laws on matters governed by state law.

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[44] The court of appeals' decision may also affect claims of unsecured creditors under the Code. Section 726(a)(5) of the Code permits unsecured creditors to receive interest on their claims at the "legal rate" before the debtor receives any payments. It is not clear from the scant legislative history at what rate, if any, interest is to be paid where state law bars interest, since the "legal rate" for such a claim would be zero percent. If there is an alternative "federal" right to interest, then the state bar on payment of interest would have no effect.

CONCLUSION

For the reasons stated above, certiorari should be granted to review the judgment of the court of appeals.

Respectfully submitted,

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July 19, 1982

Office - Supreme Court, U.S.
FILED
JUL 19 1982
ALEXANDER L. STEVAS
CLERK

No. 82-106

IN THE

Supreme Court of the United States

OCTOBER TERM, 1981

GLEN CORPORATION, *et al.*,
Petitioners,

v.

O.C. ASSOCIATES, *et al.*,
Respondents.

APPENDICES TO PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

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APPENDIX A

UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

No. 81-1741

DEBENTUREHOLDERS PROTECTIVE COMMITTEE OF CONTINENTAL INVESTMENT CORPORATION,
Appellant,

v.

CONTINENTAL INVESTMENT CORPORATION,
Debtor.

No. 81-1742

THE FIRST NATIONAL BANK OF BOSTON, INDENTURE TRUSTEE,
Appellant,

v.

CONTINENTAL INVESTMENT CORPORATION,
Debtor.

No. 81-1743

O.C. ASSOCIATES,
Appellant,

v.

CONTINENTAL INVESTMENT CORPORATION,
Debtor.

No. 81-1756

BANKERS TRUST COMPANY,
INDENTURE TRUSTEE,
Appellant,

v.

CONTINENTAL INVESTMENT CORPORATION,
Debtor.

Appeals from the United States District Court
for the District of Massachusetts

[HON. A. DAVID MAZZONE, *U.S. District Judge*]

Before
CAMPBELL and BREYER, *Circuit Judges*,
and WYZANSKI,* *Senior District Judge*

Frederick G. Fisher, Jr., with whom *Hale and Dorr* was on brief, for appellant Debentureholders Protective Committee of Continental Investment Corporation.

Harvey R. Miller, with whom *Bruce R. Zirinsky*, *Jeffrey L. Tanenbaum*, *Cara N. Nash*, and *Weil, Gotshal & Manges* were on brief, for appellant O.C. Associates.

Victor Bass, with whom *Erik D. Lazar*, and *Palmer & Dodge* were on brief, for appellant The First National Bank of Boston.

Jon D. Schneider, with whom *Raymond C. Zemlin*, and *Goodwin, Procter & Hoar* were on brief, for appellant Bankers Trust Company.

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* Of the District of Massachusetts, sitting by designation.

William F. Macauley, with whom *John A.K. Grunert*, *Craig and Macauley Professional Corporation*, *Richard E. Bachman*, and *Hale, Sanderson, Byrnes & Morton* were on brief, for appellees Glen Corporation, et al.

Daniel M. Glosband, with whom *Richard T. D'Elia*, *Gayle M. Merling*, and *Goldstein & Manello* were on brief, for appellee Paul Lazzaro, Trustee of Continental Investment Corporation.

April 30, 1982

WYZANSKI, *Senior District Judge*. These four appeals raise the issue whether the district court erred in confirming a plan of reorganization of Continental Investment Corporation ["CIC"], a *solvent* debtor involved in proceedings pursuant to chapter X of the Bankruptcy Act, 11 U.S.C. ch. X § 701 *et seq.*, because the plan did not provide that CIC's convertible debenture holders or its straight debenture holders should receive payment of interest on overdue instalments of interest.

In 1970 and 1973 CIC issued two classes of debentures which may fairly be summarized by us as follows:

> 1. 9% Convertible Subordinated Debentures ["Convertible Debentures"] due November 1, 1990 had been issued by CIC pursuant to an Indenture dated November 1, 1970 ["1970 Indenture"]. The 1970 Indenture provides for 9% interest to be paid semi-annually on November 1 and May 1 of each year and for *the payment of interest both on principal and on any overdue instalments of interest* at the annual rate of 9%. It also provides that "[t]his Indenture and each Debenture shall be deemed to be a contract made under the laws of the Commonwealth of Massachusetts, and for all purposes shall be construed in accordance with the laws of said State."

2. 9% Subordinated Debentures ["Straight Debentures"] due November 1, 1985 had been issued by CIC pursuant to an Indenture dated March 1, 1973 ["1973 Indenture"]. The 1973 Indenture provides for 9% interest to be paid semi-annually on November 1 and May 1 of each year and for *the payment of interest both on principal and on any overdue instalments of interest* at the annual rate of 9%. It also provides that "[t]his Indenture and each Debenture shall be deemed to be a contract made under the laws of the State of New York, and for all purposes shall be construed in accordance with the laws of said State."

The provisions for payment of interest on overdue instalments of interest (referred to in the above two paragraphs) are virtually identical.

CIC made its last interest payments to the holders of each class of debentures on May 1, 1974. CIC is in default on payments due on November 1, 1974 and thereafter.

On April 10, 1976 CIC filed a petition under chapter XI of the Bankruptcy Act, former 11 U.S.C. § 101 *et seq.* On May 7, 1976 First National Bank of Boston, "pursuant to Section 8.02" [1] of the 1970 Indenture, filed

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[1] § 8.02 of the 1970 Indenture and § 7.02 of the 1973 Indenture each provide:

> CIC covenants that (1) in case default shall be made in the payment of any instalment of interest on any of the Debentures, as and when the same shall become due and payable, and such default shall have continued for a period of thirty days, or (2) in case default shall be made in the payment of the principal of . . . any of the Debentures when the same shall have become due and payable, whether upon maturity of the Debentures or upon redemption or upon declaration or otherwise—then, upon demand of the Trustee, CIC will pay to the Trustee, for the benefit of the holders of the Debentures, the whole amount that then shall have become due and payable on all such Debentures for principal . . . or interest, as the case

a proof of claim for the holders of convertible debentures. On May 24, 1976 Bankers Trust Co. filed a proof of claim for all holders of straight debentures "in accordance with the provisions of the" 1973 Indenture.

On June 5, 1981 the Trustee in bankruptcy proposed a plan of reorganization of CIC [the "Trustee's Plan"] providing that the Trustee shall (1) sell for $166 million all of the stock of the debtor, CIC, to Liberty National Insurance Holding Company ["Liberty"], (2) pay all administrative claims, (3) pay in 1981 to each debenture holder of each class of debentures the full amount of the principal of each debenture plus all overdue instalments of interest, but *nothing on account of interest on the overdue instalments*, (4) pay to each ordinary creditor the principal of his claim plus "interest if the creditor would have been entitled to such interest under applicable general laws" [Plan ¶ 9.6, A.125], (5) have an option to purchase from Liberty for $14 million all the stock of ConVest, a subsidiary of CIC, and (6) distribute to each stockholder of CIC his ratable part of any ConVest stock bought by the Trustee and to pay him his ratable part of the cash balance of the proceeds of the sale of CIC assets to Liberty.

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may be, *with interest upon the overdue principal . . . and instalments of interest (to the extent permitted by law)* at the rate of interest borne by the Debentures . . .

. . . . .

In case there shall be pending proceedings for the bankruptcy or for the reorganization of CIC . . . under the National Bankruptcy Act . . . the Trustee, irrespective of whether the principal of the Debentures shall then be due and payable as therein expressed or by declaration or otherwise and *irrespective of whether the Trustee shall have made any demand pursuant to the provisions of this Section* . . . shall be entitled and empowered, by intervention in such proceedings or otherwise, to file and prove a claim or claims for the whole amount of principal . . . and interest owing and unpaid in respect of the Debentures . . . [Emphasis added.]

. . . . .

Both classes of debenture holders objected to the Trustee's Plan on the ground that it failed to meet their claims for interest on the overdue instalments of interest on the debentures, and the straight debenture holders objected on the further ground that it failed to allow them post-petition interest on the so-called "accrued" pre-petition interest on the unpaid 1974 and 1975 instalments of interest.

The district court denied the claims and overruled the objections. With respect to the straight debenture holders' contentions, the court gave two reasons for its denial: (1) that the provision for payment of interest on the overdue instalments of interest is void under New York law, and (2) that the enforcement of a provision for interest on overdue instalments of interest would not be fair and equitable inasmuch as the principal amount of each debenture will be paid 4 years in advance of the 1985 maturity date, and the pre-paid principal may be invested for 4 years in United States Treasury obligations due in 1985 paying over 15%, instead of the 9% rate which would have been payable on a straight debenture due in 1985. With respect to the convertible debenture holders' claims, the court gave as the reason for its denial that the maturity date of those convertible debentures was 1990 and the pre-paid principal may be invested in Treasury obligations paying over 13% instead of the 9% rate which would have been payable on a convertible debenture due in 1990.

On September 16, 1981 the court, after finding CIC solvent,[2] confirmed the Trustee's Plan. Since that date the Plan has been substantially consummated; but the

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[2] The district court's June 18, 1981 opinion (concluding that the Trustee's Plan was fair and equitable) and its September 9, 1981 opinion (relating to interest on overdue instalments of interest) include findings indicating that CIC's total liabilities were less than *$114 million* and that, *in addition to other assets*, CIC had the benefit of a *$159 million* promise made by a promisor with "more than sufficient resources." (A.430).

Trustee has retained over $3 million to meet the present appellants' claims if they should prevail.

The four appeals before us raise in different contexts the question whether the district court properly found that the Plan was, within the meaning of 11 U.S.C. § 221(2), "fair and equitable" inasmuch as the Plan did not provide for the payment of interest on unpaid instalments of interest due on the two classes of CIC debentures. The straight debenture holders also raise the question whether the plan is unfair in not providing for the payment of pre-petition and post-petition interest on the unpaid 1974 and 1975 instalments of interest.

We consider first the appeal of the First National Bank of Boston ["FNBB"] which, as trustee under the 1970 Indenture, presented to the district court the claims of holders of convertible debentures to be paid 9% interest on the unpaid instalments of interest.

FNBB's proof of claim, as interpreted by the district court,[3] and by us, presents two types of claims: claims

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[3] The district judge stated that "the debenture holders [of both classes] now argue that they are entitled to be paid interest on the instalments of interest unpaid since the pre-reorganization period." (A.4) FNBB did not on behalf of the convertible debenture holders file a proof of claim or make an argument on the theory that they were entitled to post-petition interest on the pre-petition interest on the instalments of interest due in 1974 and 1975. Hence we need not consider whether a claim for such post-petition interest would have been a valid claim under federal bankruptcy law even though there was no specific provision in the 1970 Indenture referring to such interest on unpaid interest upon unpaid instalments of interest (thus not being a claim "based . . . on the terms of the agreement," *see* Justice Frankfurter concurring in *Vanston Bondholders' Protective Committee* v. *Green*, 329 U.S. 156 (1946), p. 171, lines 16-17). If there had been a claim for such post-petition interest (on interest on instalments of interest), the rate would be 8 rather than 9%. This is so because a contract creditor whose claim rests on a debtor's breach of an obligation to pay a liquidated sum is entitled to receive post-petition interest at the statutory or other general rate before any surplus reverts to the debtor—at least where the debtor is proved solvent, and even if

for pre-petition interest on interest (that is, interest up to April 30, 1976 on the three instalments of interest due November 1, 1974, May 1, 1975, and November 1, 1975 which were unpaid on April 30, 1976 when the petition was filed) and claims for *post-petition* interest (that is, (1) interest beginning April 30, 1976 on the three instalments due in 1974 and 1975—but not including interest on the unpaid pre-petition interest on those three instalments (*see* footnote 3 *supra*)—together with (2) interest on the instalments of interest which fell due after the petition, and of which the first was the May 1, 1976 instalment).

As an introduction to our analysis of FNBB's two-fold claim, we note that the conflict-of-law problems with respect to pre-petition claims are different from the conflict-of-law problems with respect to post-petition claims.

Pre-petition interest is governed by state law, absent an overruling federal law. In *Vanston Bondholders Protective Committee* v. *Green*, 329 U.S. 156, 161 (1946), Justice Black, writing for a majority of the court, expressed the principle thus: "What claims of creditors are valid and subsisting obligations against the bankrupt at the time a petition in bankruptcy is filed is a question which, in the absence of overruling federal law, is to be determined by reference to state law." In the same case, Justice Frankfurther, writing a concurring opinion for himself and Justices Jackson and Burton, expressed the same principle thus at p. 170: "no obligation finds its way into a bankruptcy court unless, by the law of the State where the acts constituting a transaction occur, the legal consequence of such a transaction is an obligation to pay." State law may allow pre-petition interest either because the parties have so contracted or because under state rules governing contracts a person who breaks a

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the creditor's contract does not so specify. Otherwise, the debtor would benefit unjustly from the use of money due and owing to the creditor (who presumably could have used the money to earn the market rate of interest).

contract for a liquidated sum must pay as part of the damages interest from the date of the breach. *See Manganaro Drywall, Inc.* v. *Penn-Simon Construction Co.*, 357 Mass. 653, 657-658 (1970); *In re International Hydro-Electric System*, 101 F.Supp. 222 (D. Mass. 1951); Restatement (Second) Contracts § 354 Comment c.

Post-petition interest questions arise in two different situations. (1) If there is a contract between the creditor and the bankrupt either for interest on the principal or for interest on unpaid interest on the principal, and if this is a valid contract under the law of the State which governs the contract, then the federal bankruptcy law determines whether the contract is enforceable in bankruptcy. As Justice Black stated in *Vanston*, p. 163: "When and under what circumstances federal courts will allow interest on claims against debtors' estates being administered by them has long been decided by federal law." Justice Frankfurter in *Vanston*, p. 171 noted: "We do not reach considerations of policy in bankruptcy administration until there are rights, created by applicable local law, to be recognized." (2) If the creditor and the bankrupt have not made a valid contract as to interest, nonetheless, the bankruptcy court has the *power* to award interest on the theory that there has been a detention by the bankruptcy court of monies due. However, as we shall later explain, the bankruptcy court usually does not make such awards unless the alleged bankrupt is *solvent*. *United States* v. *Bass*, 271 F.2d 129, 130 (9th Cir. 1959). *See New York* v. *Saper*, 336 U.S. 328, 330 n.7 (1949).

With respect to both the pre-petition and the post-petition claims of the convertible debenture holders, the following two matters are undisputed: (1) insofar as state law governs the case, it is the law of Massachusetts which controls, and (2) under Massachusetts law a contractual provision that interest shall be paid on an instalment of interest not seasonably paid is valid. *Man-*

ganaro Drywall, Inc. v. *Penn-Simon Construct Co.* and *In re International Hydro-Electric System*, both *supra*.

If CIC were *insolvent*, the indenture provision allowing the post-petition interest on the instalments which fell due either before or after the petition was filed would not be enforceable, regardless of State law. *Vanston*, p. 159 lines 23-24, pp. 163-166. The federal bankruptcy rule, derived from English law, provides that in the case of *insolvent* debtors interest, whether stipulated in a contract or not, stops at the moment the petition in bankruptcy is filed. *Sexton* v. *Dreyfus*, 219 U.S. 339, 344 (1911); *American Iron Co.* v. *Seaboard Air Line*, 233 U.S. 261, 267-268 (1914). *See New York* v. *Saper*, 336 U.S. 328, 330 (1949). Two reasons are given for the rule: (1) interest payments are penalties or damages assessed against the debtor for his detention of the creditor's money (*see Vanston*, pp. 166, 171) and therefore it would be unjust to allow the creditor to recover such penalties or damages from other creditors who were not to blame for the detention; and (2) the bankruptcy court itself, not the debtor, detained the money after the petition was filed.

But with respect to post-petition interest on both the unpaid instalments which fell due before, and the unpaid instalments which fell due after, the petition, the legal situation is different when the supposed bankrupt proves to be *solvent*. Where the debtor is *solvent*, the bankruptcy rule is that where there is a *contractual* provision, valid under state law, providing for interest on unpaid instalments of interest, the bankruptcy court will enforce the contractual provision with respect to both instalments due before and instalments due after the petition was filed. *Ruskin* v. *Griffiths*, 269 F.2d 827, 830-832 (2nd Cir. 1959), *cert. den.* 361 U.S. 947 (1960); *In re Hydro-Electric System*, *supra*, 224. This rule is fair and equitable inasmuch as the solvent debtor's estate will have been enriched by the bankruptcy trustee's use of money

which the debtor had promised to pay promptly to the creditor, and, correspondingly, the creditor will have been deprived of the opportunity to use the money to *his* advantage. Moreover, the rule does not in any way affect any creditor other than the claimant of interest on interest. Finally, the rule is in harmony with the settled English and American law that when an alleged bankrupt is proved solvent, the creditors are entitled to receive post-petition interest before any surplus reverts to the debtor. *New York* v. *Saper*, 336 U.S. 328, 330 n.7 (1949); *United States* v. *Bass*, 271 F.2d 129, 130 (9th Cir. 1959); *Littleton* v. *Kincaid*, 179 F.2d 848, 27 A.L.R.2d 572 (4th Cir. 1950).

The district court, while assuming that a convertible debenture holder had a contractual right to a cash payment of interest on interest, required him to take as a substitute for that contractual right a different right—the right to a 1981 payment of the principal of the debenture which, had there been no default in payment of interest and no petition in bankruptcy, would not have matured until 1990.

FNBB contends that in the case of a solvent debtor the court lacked power to compel the acceptance of any substitute, that if the court had such power what the court offered gave nothing to the convertible debenture holders which they did not already have, and that therefore the plan did not meet the 11 U.S.C. § 221(2) requirement of being fair and equitable.

In considering those contentions, we must be mindful that the "determination of the district court as to the fairness of the plan will not be set aside unless clearly shown to be erroneous." *Horowitz* v. *Kaplan*, 193 F.2d 64, 71 (1st Cir. 1951), *cert. den.*, 342 U.S. 946 (1952).

We do not find it necessary to decide whether the district court—in connection with a plan of reorganization of a *solvent* debtor, especially one (1) which is not going

to continue in business, (2) which under the reorganization plan will not have creditors holding securities issued by the debtor before the plan or as a consequence of the plan, and (3) which has cash or its equivalent [4] sufficient to pay in full the whole amount of all creditors' claims including interest upon unpaid interest—has the power, *in the sole interest of the stockholders* to require a creditor (such as the convertible debenture holder represented by FNBB) who has a contractual right to interest on interest to surrender such right in exchange for a different right having equal financial value but being unwanted by the creditor. Nor need we decide whether to compel such a surrender solely for the benefit of stockholders is a violation of the "absolute priority rule," the scope of which is indicated in the following quotation: "Whether a company is solvent or insolvent in either the equity or the bankruptcy sense, 'any arrangement of the parties by which the subordinate rights and interests of the stockholders are attempted to be secured at the expense of the prior rights' of creditors 'comes within judicial denunciation.'" *Consolidated Rock Products Co.* v. *Du Bois*, 312 U.S. 510, 527 (1941).

Even if it is not the law that in the case of a *solvent* debtor *any* compulsory exchange of a creditor's *contractual* right to cash for a substitute which he did not want and which benefits only stockholders would make a reorganization plan unfair and inequitable, and would make confirmation of the Trustee's Plan *ultra vires* of the district court, in the case at bar the Trustee's Plan is "clearly shown" (*see Horowitz* v. *Kaplan, supra*) to be unfair and inequitable because the Trustee's Plan does not provide in exchange for the creditor's contractual right just compensation. We pass the point that there was not before the district court any evidence of the monetary value of the contractual right to the unpaid interest on interest on the convertible debentures. It is

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[4] *See* footnote 2 *supra*.

sufficient for us to note that by the specific terms of the 1970 Indenture (quoted in footnote 1, *supra*) long before any plan of reorganization was formulated, the convertible debenture creditors had become entitled to immediate (not just 1990) payment of the principal and unpaid instalments of interest on their debentures as well as to interest on interest. Section 8.02 of the 1970 Indenture provided that "In case there shall be pending proceedings . . . for the reorganization of CIC," the Trustee "shall be entitled" "to file and prove a claim . . . for the whole amount of principal . . . and interest owing and unpaid in respect of the Debentures." We hold that FNBB's May 7, 1976 proof of claim [5] accelerated to May 7, 1976 the payment date of the principal of the de-

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[5] We have already construed FNBB's proof of claim as covering (1) principal, (2) pre-petition unpaid 1974 and 1975 instalments of 9% interest, (3) pre-petition unpaid 9% interest on such unpaid 1974 and 1975 instalments and (4) post-petition contractual 9% interest on unpaid 1974 and 1975 instalments of interest but not post-petition non-contractual interest on what at the time of the petition was the amount of interest due on account of those unpaid 1974 and 1975 instalments of interest. See footnote 3, *supra*. We further construe the proof of claim as covering (5) instalments of 9% interest which fell due after the petition and (6) 9% interest on such post-petition instalments. We recognize that this further construction involves a liberal interpretation of a proof of claim which recites merely that it seeks "interest owing and unpaid in respect of the Debentures." A strict construction might treat the proof of claim as limited to interest owing at the time the proof of claim was filed. Were that the construction, items 5 and 6 would not be allowed, and instead the convertible debenture holders would get 8% on principal as post-petition interest payable by a solvent debtor on all liquidated contract claims whether or not the contract specifically provided for interest from the time of the breach of the contract. See *New York* v. *Saper*, *United States* v. *Bass* and *Littleton* v. *Kincaid*, all *supra*. But we deem it fairer to view the proof of claim as seeking all interest specifically provided for by the 1970 Indenture whether or not it was owing and unpaid when the petition was filed. Our reasoning is supported by the fact that § 8.02 of the 1970 Indenture and § 7.02 of the 1970 [*sic*, 1973] Indenture make mention of the "whole amount" owing and unpaid.

bentures. Therefore, we hold that the district court erred when it decided to confirm the Trustee's Plan on the court's theory that it gave the convertible debenture holders in exchange for their right to payment of interest on interest a *new* right of accelerating from 1990 to 1981 the payment of the principal of the debentures. Our ultimate conclusion is that with respect to convertible debenture holders the Trustee's Plan was not "fair and equitable" because it did not compensate them for the *contractual* right of which they were deprived.

We now turn to the three other appeals, all made on behalf of holders of straight debentures.

The straight debentures were issued pursuant to the 1973 Indenture which provided that they were governed by New York law. It is undisputed that that conflict-of-laws provision was valid.

One of the appellants contends that New York law permits the recovery of interest on interest. But the contention is devoid of merit. For a century the New York Court of Appeals consistently has held that a contractual provision to pay interest on interest is void under the law of New York. *Young* v. *Hill*, 67 N.Y. 162 (1876); *Newburger-Morris Co.* v. *Talcott*, 219 N.Y. 505, 510 (1916) (per Cardozo, J.); *Giventer* v. *Arnow*, 37 N.Y.2d 305 (1975). In the Supreme Court of the United States, Justices Frankfurter, Jackson and Burton—without either the dissent or the concurrence of their brethren—recognized in a bankruptcy case that those cases represented the law of New York. *Vanston*, pp. 171-172. And in an opinion by Judge Swan, concurred in by Judges Learned Hand and Jerome Frank, the Second Circuit held that interest on interest was not recoverable in bankruptcy where the claim was based on a coupon bond attached to a bond governed by New York law. *Empire Trust Co.* v. *Equitable Office Building Corp.*, 167 F.2d 346 (2nd Cir. 1948). After judges of such eminence have spoken, we need add nothing except our concurrence

in their opinion that under New York law a contractual provision to pay interest on interest is void, and our view that New York law also precludes a non-contractual right to pre-petition interest on interest. *See Young* v. *Hill, supra.*

Nonetheless, the straight debenture holders received under the Trustee's Plan less than was their due.

As we earlier stated, federal not state law determines in a bankruptcy case whether a creditor is entitled to post-petition interest on a valid pre-petition claim. *Vanston, supra,* 161-163.

Under federal bankruptcy rules the straight debenture holders are entitled to interest (here at the 8% rate which the Trustee's Plan allowed other unpaid unsecured creditors) *from the date of the petition in bankruptcy,* upon all unpaid (1) pre-petition instalments and (2) post-petition instalments, (but not upon pre-petition so-called "accrued" interest, that not being recoverable under New York law).[6] It is a general rule of federal bankruptcy law that if the alleged bankrupt proves solvent, creditors have a right to receive post-petition interest at the statutory general rate—here 8%—before any surplus reverts to the debtor. See *New York* v. *Saper*; *United States* v. *Bass, Littleton* v. *Kincaid,* all *supra.*

The straight debenture holders' *non-contractual* right to interest on interest is distinguishable from the convertible debenture holders' *contractual* right to interest on interest so we need to examine from a slightly different perspective points already covered.

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[6] We have already stated that *New York* law does not give the straight debenture holders a contractual or a non-contractual right to interest on the pre-petition unpaid 1974 and 1975 instalments of interest. Therefore, no obligation to pay interest on the unpaid 1974 and 1975 instalments found its way into the bankruptcy court. See Justice Frankfurter concurring in *Vanston,* 170.

We need not decide whether with respect to such a non-contractual right it would be fair and equitable and within the district court's power (in the case of the reorganization of a *solvent* debtor which is not continuing in business, which will have no outstanding securities, and which will have had during the time the debtor was *in custodia legis* the advantage of using without cost the money due the straight debenture holders) to require a straight debenture holder to take a financially equivalent substitute in exchange for his right to post-petition interest on interest, against the will of the straight debenture holder and solely to benefit stockholders. Nor need we consider whether to compel such a deprivation of the non-contractual right to interest on interest violates the "absolute priority" rule. See 6 Collier on Bankruptcy ¶ 9.08 at 1583 (14th ed., 1978).

It suffices for us to hold that here, as with the convertible debenture holders, the Trustee's Plan offered, in exchange for the denied right to interest on interest, only that which the debenture holders already had, to wit, in the case of the straight debenture holders a right to immediate (1981, not 1985) payment of principal. That statement is based on the fact that Bankers Trust as trustee for the straight debenture holders had on May 24, 1976 filed a proof of claim which we construe as *pari passu* with the May 7, 1976 FNBB proof of claim on behalf of the convertible debenture holders. See footnote 5, *supra*. We therefore conclude, as we did with respect to the convertible debenture holders, that the Trustee's Plan was with respect to the straight debenture holders not fair and equitable and that the district court erred in confirming the Plan.

Judgment vacated; case remanded to the district court for further proceedings in accordance with this opinion.

APPENDIX B

UNITED STATES DISTRICT COURT
DISTRICT OF MASSACHUSETTS

No. 76-1158-MA

IN RE: CONTINENTAL INVESTMENT CORPORATION,
Debtor

In Proceedings for the Reorganization
of a Corporation

MEMORANDUM AND ORDER ON DEBENTUREHOLDERS ENTITLEMENT TO INTEREST ON OVERDUE INSTALLMENTS OF INTEREST

Mazzone, D.J. September 9, 1981

On June 18, 1981, I approved for transmission to the creditors and stockholders of Continental Investment Corporation (CIC) the Trustee's Third Modified Plan of Reorganization (Plan). The Plan incorporates an offer from Liberty National Insurance Holding Company (Liberty National) to purchase all the issued and outstanding shares of common stock of CIC for $166 million,[1] a value almost identical to the value I had previously and preliminarily found to be the reorganization value of CIC. The purchase agreement between Liberty National and the Trustee provides the Trustee the option to repurchase from Liberty National a wholly-owned subsidiary of CIC, ConVest Energy Corporation (ConVest), and the Trustee has stated that he intends to exercise this option. Under the Plan, the allowed claims of all creditors, including the senior bank creditors, debenture-

[1] This base price is subject to certain adjustments. The Court has previously found that the final purchase price would approximate $159,377,000.

holders and administrative creditors, will be paid in cash in full. The balance of the proceeds of the sale to Liberty, after the repurchase of ConVest, the payments to creditors, and the funding of a reserve for the payment of contested claims, will be distributed to stockholders, as will the common stock of ConVest following the repurchase.

There presently are outstanding two issues of debentures of CIC, 9% Convertible Subordinated Debentures due 1990 (Convertible Debentures) and 9% Subordinated Debentures due 1985 (Straight Debentures). CIC ceased paying interest on each of these issues of debentures at a time prior to the filing of its original petition under the Bankruptcy Act, and the debentureholders now argue that they are entitled to be paid interest on the installments of interest unpaid since the pre-reorganization period.[2] In ruling on the approval of the reorganization plan, the Court noted that the parties had agreed to the deferral of a decision on this claim. The parties were asked to submit briefs on the issues. Submissions in the form of memoranda, letters, or both have been received from the Debentureholders' Protective Committee, The First National Bank of Boston (Indenture Trustee for the Convertible Debentures), Bankers Trust Company (Indenture Trustee for the Straight Debentures), O.C. Associates (a holder of Straight Debentures), the Majority Stockholders of CIC, the Minority Shareholders' Committee, and the Trustee. Not surprisingly, the debentureholders and their representatives argue the entitlement of the debentureholders to be paid the disputed interest, while the stockholders argue that such interest ought not be paid. The Trustee has made no provision in the Plan for the payment of interest on the overdue

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[2] The assertion of holders of the Convertible Debentures that they are entitled to a premium for the loss of their prospective right to convert their debentures into shares of CIC's common stock is the subject of a compromise between the Trustee and these debentureholders, to which no objection was made and which was approved by this Court on August 21, 1981.

interest. The parties disagree as to the amount that is in dispute; estimates range from $8,222,208.75 (calculated by the Debentureholders' Protective Committee to be due on all outstanding debentures through November 1, 1981) to the Trustee's estimates (set forth in the disclosure materials filed herein) of $3,400,000 in respect of the Straight Debentures and $140,000 in respect of the Convertible Debentures, as at September 30, 1981.

I. GOVERNING LAW

Our first task is to identify the law that must govern the determination of whether the debentureholders' claim to interest is enforceable and should be enforced. We follow a procedure derived from the Supreme Court's analysis in *Vanston Bondholders Protective Committee* v. *Green*, 329 U.S. 156 (1946), that is, we first examine applicable state law to determine whether the claim being made is enforceable against the estate, and we then decide, applying equitable principles developed under federal bankruptcy law, whether we shall, in the particular factual situation presented, allow a claim that is enforceable.[3] This is the procedure followed by this Court in *In re International Hydro-Electric System*, 101 F. Supp. 222 (D. Mass. 1951).

The debentureholders base their claims on similar provisions in each of the indentures under which the debentures were issued, in which CIC convenanted that, upon a default of more than 30 days' duration in the payment of any installment of interest, CIC would pay

[3] The Supreme Court in *Vanston* did not explicitly decide whether the provision at issue there was enforceable under the laws of any of the number of states whose law could have been said to govern but, rather, assumed without deciding that the provision was enforceable and then refused to enforce it as a matter of the equitable principles governing reorganization. The Court made clear, however, its opinion that, unless federal law provides a contrary result, the validity and enforceability of claims against an estate are decided by reference to state law. 329 U.S. at 161.

to the Indenture Trustee thereunder upon its demand the total amount then due and payable, with interest on the overdue installments of interest "to the extent permitted by law" at the rate of interest borne by the debentures.[4] The indenture under which the Straight Debentures were issued provides that its terms shall be construed under the laws of the State of New York, while the indenture for the Convertible Debentures is to be construed under Massachusetts law.

A. *New York Law*

New York law is clear that "a promise to pay interest upon interest is void if made at a time before simple interest has accrued." *Giventer* v. *Arnow*, 37 N.Y. 2d 305 (1975); *Newburger-Morris Co.* v. *Talcott*, 219 N.Y. 505, 510 (1916). This would seem to end our consideration of any entitlement of the holders of the Straight Debentures to interest at the contract rate on their overdue installments of interest. However, the Debentureholders' Protective Committee urges us to examine the public policy of the state of New York giving rise to this rule, to find that CIC was not such a debtor as New York intended to protect and to find that the debentureholders took such action after their simple interest had accrued as to revive their right to additional interest.[5] We see no sound reason to do so. In the absence of a clear exception made from the New York rule by the New York courts, we find no valid reason for making an exception for the factual situation before us from a rule of broadly-stated applicability. Nor do we find the

[4] This provision is found in Section 8.02 of the Indenture of November 1, 1970, under which the Convertible Debentures were issued, and in Section 7.02 of the Indenture of March 1, 1973, under which the Straight Debentures were issued. Each of the issues of debentures bears interest at 9%.

[5] Bankers Trust Company, Indenture Trustee, argues that New York's policy disfavoring compound interest is "obsolete" and likely to be changed on further consideration by the state's highest court.

existence of an agreement made after the accrual of the interest and accompanied by new consideration. *See Young* v. *Hill*, 67 N.Y. 162 (1876). The provision in the indenture for the Straight Debentures that provides for the payment of interest on the overdue installments of interest is void under New York law; the holders of those debentures have no valid claim to the additional interest that we may choose to enforce against the debtor.

B. *Massachusetts Law*

In an earlier decision concerning the enforceability, in a rearrangement under the Public Utility Holding Company Act of 1935, of a contractual provision for the payment of interest on overdue installments of interest after default, this Court determined that "where interest on overdue interest is expressly provided for by the terms of the contract such a provision is enforceable in Massachusetts." *In re International Hydro-Electric System*, 101 F. Supp. at 224. We find nothing in more recent law to disturb our holding, and we conclude that the provision in the Indenture of November 1, 1970 for the payment of interest on interest on the Convertible Debentures is enforceable under Massachusetts law.

II. EQUITABLE CONSIDERATIONS

Our conclusion that a certain contractual provision is enforceable as against the estate of an entity in reorganization is not dispositive of the claim thereon. The Supreme Court in *Vanston* required a second level of scrutiny of a claim:

> [A]ssuming, arguendo, that the obligation for interest on interest is valid under [state law], we would still have to decide whether allowance of the claim would be compatible with the policy of the Bankruptcy Act . . . [B]ankruptcy courts must administer and enforce the Bankruptcy Act as interpreted by this Court in accordance with authority

> granted by Congress to determine how and what claims shall be allowed under equitable principles.

329 U.S. at 162-163.

We now determine, as this Court did in *Hydro-Electric*, whether the enforcement of a provision for interest on overdue installments of interest would be fair and equitable, given the circumstances of the particular matter before us. *See Hydro-Electric*, 101 F. Supp. at 224-25.

We note, at the outset, that CIC is solvent and that the consummation of the sale to Liberty National will permit the payment of all creditors in full and in cash. Not only will the claims to be paid include the installments of interest due and unpaid since before the reorganization proceeding began, but the principal balances of the two issues of debentures will be paid in full, although neither issue has yet matured, and interest will be paid on the principal at the contract rate to the date of its payment.

The debentureholders whose indenture is governed by Massachusetts law can surmount the hurdle of enforceability of their claim under state law. We believe, however, that in this case it would be inequitable to enforce the contractual provision for interest on interest. The circumstances surrounding this claim are dominated by one important fact: the principal amounts of the bonds are to be paid approximately nine years before the bonds' stated maturity. The debentureholders point out that the value of a claim, paid at face value some years after it becomes due, is less than its value had it been paid in full when due, because the claimant has been denied the use of his funds, and the profit therefrom, during the intervening years. But the converse of this proposition is true as well: a claimant receives more than full value when his claim is paid at face value some years *before* maturity, particularly where, as here,

the return he may expect to receive from the investment of his funds exceeds the interest the unpaid claim would bear.[6] There is no inequity to the debentureholders in a plan that refrains from compensating them for a delay in the payment of their interest when that same plan does not require them to forego the advantage they gain from early payment of their principal.

III. THE ABSOLUTE PRIORITY RULE

A second ground is said to exist for the allowance of the debentureholders' claims to interest on interest. It is argued that the absolute priority rule applicable in Chapter X proceedings requires that, when the debtor is solvent, interest be paid on all creditors' claims before the stockholders may share in any distribution under a reorganization plan. It is said to follow that, because the debentureholders had a pre-petition "claim" for the unpaid installments of interest, they are entitled to interest on this "claim" at least at the rate at which interest would be payable to general unsecured creditors.

The absolute priority rule, however, is not so simplistic in its application. It is a means of interpreting the "fair and equitable" standard of Section 221(2) of the Bankruptcy Act and cannot be divorced from the concept of fairness and equity. If the absolute priority rule mandated that a solvent debtor pay interest on the interest portion of a claim, when such interest on interest would otherwise be barred by equity or state law, an anomaly would result in which interest on interest could not be paid prior to the bankruptcy date, but would be compelled thereafter. Such a result would emasculate the doctrine of *Vanston* and its progeny, for it would force the resumption of interest accruals on the date a (sol-

[6] The Court notes that recent editions of the Wall Street Journal report that most obligations of the United States Treasury due in 1985 were yielding over 15%, while all but one of those due in 1990 were yielding well over 13%.

vent) debtor filed in reorganization even in a situation in which the court determined such payment of interest on interest to be inequitable or contrary to applicable law.

An exception to a strict application of the absolute priority rule to the payment of interest was recognized in *In re Imperial "400" National, Inc.*, 374 F. Supp. 949 (D.N.J. 1974), wherein the court stated that

> [W]ith respect to [post-petition] interest on instruments that specifically set forth a contractual rate of interest, interest computed at the contractual rate will be a proper portion of the claim, *Ruskin* v. *Griffiths*, 269 F.2d 827, 830 (2d Cir. 1959), *cert. denied*, 361 U.S. 947, 80 S.Ct. 402, 4 L.Ed.2d 381 (1960), *unless modified by previous or future court orders for good cause, Vanston Bondholders Protective Committee* v. *Green*, 329 U.S. 156, 67 S.Ct. 237, 91 L.Ed. 162 (1946), *reh. denied*, 329 U.S. 833, 67 S.Ct. 497, 91 L.Ed. 706.

Id. at 954 (emphasis added).

The Court believes this is a case in which there is good cause to modify the claims. To repeat, the purpose of the absolute priority rule is to ensure that a plan is fair and feasible. The rule does require that creditors be given priority over stockholders, but it also requires that the stockholders receive so much of the debtor's assets that remain after the rightful claims of creditors have been satisfied. The rule is not intended to penalize the stockholders. Indeed the benefits of a reorganization should be preserved as much as possible for them since they are at the mercy of the absolute priority rule. I make no distinction of debentureholders. All debentureholders, whether they acquired their claims at the original issue or during the course of these proceedings, should not be excessively compensated at the expense of the stockholders simply because there is now cash to satisfy their claims rather than the common stock con-

templated under earlier plans. The fact remains that under all the circumstances presented here, the holders of these debentures, not yet matured, receive more than their original investment promised at an earlier point in time.

CONCLUSION

Recognizing that both indentures under which debentures were issued state a rate of interest to be paid on overdue installments of interest, we hold there to exist good cause for denying the debentureholders' claim to interest on their unpaid interest, for the reason that, in one instance, this claim is unenforceable under state law and, in both instances, the debentureholders are receiving ample compensation for their claims by the payment of their principal considerably in advance of maturity.

/s/ A. David Mazzone
United States District Judge

APPENDIX C

UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

No. 81-1741

IN RE CONTINENTAL INVESTMENT CORPORATION,
Debtor.

DEBENTUREHOLDERS PROTECTIVE COMMITTEE OF CONTINENTAL INVESTMENT CORPORATION,
Appellant.

No. 81-1742

IN RE CONTINENTAL INVESTMENT CORPORATION,
Debtor.

FIRST NATIONAL BANK OF BOSTON,
Appellant.

No. 81-1743

IN RE CONTINENTAL INVESTMENT CORPORATION,
Debtor.

O.C. ASSOCIATES,
Appellant.

No. 81-1756

IN RE CONTINENTAL INVESTMENT CORPORATION,
Debtor.

BANKERS TRUST COMPANY, ETC.,
Appellant.

JUDGMENT

Entered April 30, 1982

These causes came on to be heard on appeals from the United States District Court for the District of Massachusetts, and were argued by counsel.

Upon consideration whereof, It is now here ordered, adjudged and decreed as follows:

The order of the District Court is vacated and the cause is remanded to the District Court for further proceedings in accordance with the opinion filed this day.

Costs to appellants.

By the Court:

/s/ Dana H. Gallup
Clerk

APPENDIX D

STATUTES INVOLVED

Section 63a of the Bankruptcy Act of 1898, 11 U.S.C. § 103, provides in relevant part:

> § 63. Debts Which May Be Proved. a. Debts of the bankrupt may be proved and allowed against his estate which are founded upon (1) a fixed liability, as evidenced by a judgment or an instrument in writing, absolutely owing at the time of the filing of the petition by or against him, whether then payable or not, with any interest thereon which would have been recoverable at that date or with a rebate of interest upon such as were not then payable and did not bear interest; . . . (5) provable debts reduced to judgments after the filing of the petition and before the consideration of the bankrupt's application for a discharge, less costs incurred and interest accrued after the filing of the petition and up to the time of the entry of such judgments; . . . (8) contingent debts and contingent contractual liabilities; or (9) claims for anticipatory breach of contracts, executory in whole or in part, including unexpired leases of real or personal property: . . . .

Section 221 of the Bankruptcy Act of 1898, 11 U.S.C. § 621, provides in relevant part:

> Sec. 221. The judge shall confirm a plan if satisfied that— . . . (2) the plan is fair and equitable, and feasible; . . .

Office - Supreme Court, U.S.
FILED
AUG 18 1982
ALEXANDER L. STEVAS
CLERK

No. 82-106

IN THE

Supreme Court of the United States

October Term, 1982

GLEN CORPORATION, *et al.*,
Petitioners,

against

O.C. ASSOCIATES, *et al.*,
Respondents.

BRIEF FOR RESPONDENT O.C. ASSOCIATES IN OPPOSITION

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August 18, 1982

Question Presented

Is a reorganization plan "fair and equitable" if it permits stockholders of the debtor to receive substantial payments while creditors are to receive less than full compensation for the debtor's use of their money?

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No. 82-106

IN THE

Supreme Court of the United States

October Term, 1982

GLEN CORPORATION, *et al.*,

Petitioners,

against

O.C. ASSOCIATES, *et al.*,

Respondents.

BRIEF FOR RESPONDENT O.C. ASSOCIATES IN OPPOSITION

This brief is submitted on behalf of respondent O.C. Associates[1] in opposition to a petition by Glen Corporation, Monte J. Wallace, Neil W. Wallace and the Minority Stockholders Committee of Continental Investment Corp. ("CIC") (the "petitioners")[2] for a writ of certiorari to review a judgment and opinion of the United States Court of Appeals for the First Circuit[3] entered in this case on

1. O.C. Associates is a partnership whose general partners are affiliates of Oppenheimer & Co. and the Charter Company.

2. The Wallaces were the founders and principal officers of CIC, and controlled in excess of 60 percent of the stock of CIC.

3. *See* Appendix A. All references to "Appendix" refer to the appendices annexed to the petition for writ of certiorari (the "Petition"); specific pages within the Appendix will be designated by a number followed by the letter "a". The First Circuit's decision reversed the decision of the United States District Court for the District of Massachusetts. *See* Appendix B.

April 30, 1982.[4] The First Circuit held that the reorganization plan for CIC violated the "fair and equitable" rule of Chapter X of the Bankruptcy Act because it failed to give creditors of CIC (including this respondent) full compensation for their claims, while providing for distributions of about $40 million to stockholders of CIC. Specifically, the First Circuit held that where the debtor is solvent, to satisfy the fair and equitable rule, a rule of "absolute priority" in Chapter X cases, the reorganization plan must compensate holders of CIC debentures for the debtor's use of their money, including both principal and unpaid installments of interest, during the five years that the reorganization case was pending.

Statement of the Case

The decision below raises no question warranting review by this Court because it followed two well-settled rules of bankruptcy law: first, the entitlement to post-petition interest on valid claims is a matter of federal, not state law; and, second, when the debtor is solvent, under Chapter X of the Bankruptcy Act[5] creditors are entitled to

4. This action, entitled *O.C. Associates* v. *Continental Investment Corp.*, No. 81-1743, was consolidated with three other cases in the court of appeals: *Debentureholders Protective Comm. of Continental Investment Corp.* v. *Continental Investment Corp.*, No. 81-1741; *Bankers Trust Co., Indenture Trustee* v. *Continental Investment Corp.*, No. 81-1756; and *First National Bank of Boston, Indenture Trustee* v. *Continental Investment Corp.*, No. 81-1742. The Petition herein seeks review of the decision in the first three of these cases, but not the fourth.

5. Former 11 U.S.C. §§ 101 *et seq.* On November 6, 1978, Congress enacted the Bankruptcy Reform Act of 1978, replacing the Bankruptcy Act (the "Act") with the new Bankruptcy Code (the "Code"), 11 U.S.C. §§ 101 *et seq.* The Act, not the new Code, is applicable to this case. *See* Bankruptcy Reform Act of 1978, tit. IV, § 403(a), 92 Stat. 2683.

receive, under the Act's "fair and equitable" rule, full compensation for all of their claims, including post-petition interest on claims for accrued interest, before the stockholders of the debtor may receive anything. In following those black letter rules the court of appeals rendered a very narrow decision which creates no conflict, wreaks no havoc, and does not, as the Petition suggests, create a "new federalism" under which the rights of the states will be trampled underfoot.

Furthermore, the points raised in the Petition are rendered largely academic by the enactment of the Bankruptcy Code, which superseded the Bankruptcy Act on October 1, 1979, because the Code explicitly requires solvent debtors to pay post-petition interest on *all* creditor claims. Thus, any dispute on this point which might arise under the old Bankruptcy Act is essentially of historical interest only.

Facts

At the time CIC filed its voluntary petition under the Bankruptcy Act on April 30, 1976, it had already defaulted on payments of over $6 million in interest due to its debentureholders, respondents herein. CIC had the use of that money for over 5 years, while the reorganization case was pending. During those five years approximately $17 million in additional interest installments became due, but were once again not paid. CIC also had the use of this $17 million while its reorganization case was pending. The district court found the estate of CIC to be solvent, and it is not disputed that there is enough money to pay interest to the debentureholders to compensate them for this extended use of their funds.

If interest is denied, CIC and its stockholders (*i.e.*, petitioners)—who received $40 million at the conclusion of the reorganization case—will have received a windfall of over $6 million, which represents the interest which the debentureholders could have earned on this money during the period while this case was pending (conservatively calculated at the "legal" 8 percent rate of interest). The First Circuit properly ruled that it would not be fair and equitable to give CIC's stockholders such a windfall, at the debentureholders' expense. That is the ruling which petitioners ask this Court to review.

Background

In 1973, CIC issued 9% subordinated debentures in the aggregate principal amount of $37,158,900 (the "debentures").[6] Principal on the debentures was due in 1985; interest was payable in semi-annual installments. The indenture under which the debentures were issued provides that New York law governs the construction and enforceability of the debentures. In November 1974, CIC stopped paying interest due under the debentures and made no further payments up to April 30, 1976, when it filed its petition in the District Court for the District of Massachusetts.[7]

On May 24, 1976, a proof of claim was filed for all holders of the debentures, in the total amount of $43,838,212.28, consisting of $37,158,000 in principal, plus interest,

6. CIC had previously issued $30,000,000 in convertible debentures. The First Circuit's decision granting post-petition interest to those debentureholders is not challenged in the Petition.

7. CIC's petition originally sought an arrangement under Chapter XI of the Bankruptcy Act; the case was later converted to a Chapter X case.

of which $6,679,312.28 was due and payable as of April 30, 1976. The claims of the debentureholders were allowed by the court and are not challenged in the Petition. All that is at issue is the proper amount of post-petition interest which should be awarded on those claims.

The Trustee's Third Modified Plan of Reorganization for CIC (the "Plan") included a stock purchase agreement between Liberty National Insurance Holding Co. ("Liberty") and the Trustee, which provided for the purchase by Liberty of all the issued and outstanding common stock of CIC for $166 million. In its order confirming the Plan, the district court found that the reorganization value of CIC was $166 million, and that, because the claims against the CIC estate were substantially less than that amount, "CIC is therefore solvent." It is undisputed that sufficient funds exist to pay the claims of all creditors, in full, including all claimed post-petition interest thereon.

The Plan provided that the "allowed claims" of all creditors were to be satisfied in full in cash. The Plan further provided that creditors were to receive post-petition interest on their claims. Where those claims did not arise out of an instrument or agreement with a specified rate of interest, the creditors were to receive post-petition interest on their claims computed at the legal rate of 8 percent per year.[8] However, the debentureholders were to receive post-petition interest only on their claims for the principal amount of the debentures; they were denied *any* post-petition interest on the portion of their allowed claims

8. Thus, in the Plan, the Trustee recognized the right of creditors to receive post-petition interest on their claims in the context of a solvent debtor's estate, even in the absence of an agreement providing for such interest. This is the very principle of bankruptcy law confirmed by the First Circuit in the decision below.

which consisted of unpaid installments of interest. After the satisfaction of allowed claims of all creditors, CIC's stockholders were to receive the balance of the $166 million received from Liberty National, which was about $40 million.[9]

The Decisions Below

In its Memorandum and Order dated September 9, 1981, the district court rejected the debentureholders' claims for post-petition interest on that portion of their allowed claims represented by unpaid installments of interest. The district court decided that state law "must govern the determination of whether the debentureholders' claim to interest is enforceable and should be enforced" (19a). On the basis of its construction of governing New York law the district court decided that the debentureholders "have no valid claim to the additional interest that [the court] may choose to enforce against the debtor" (21a). In support of its decision the district court also noted that the principal amount of each subordinated debenture would be paid four years in advance of the 1985 maturity date (22a-23a).[10]

9. Prior to approval of the Plan, representatives of the convertible and subordinated debentureholders asserted their rights to post-petition interest (through the date of payment) on their *entire* allowed claims. The issue of the debentureholders' entitlement to post-petition interest was deferred until after the district court's approval of the Plan. The debentureholders and other creditors were not afforded the opportunity to vote to accept or reject the Plan because the court determined that their rights were not being affected thereby, inasmuch as they would be entitled to receive payment in the full amount of their claims.

10. With respect to the convertible debentures, the district court found that while applicable Massachusetts law permitted agreements to pay such interest, payment of the full amount of principal due the debentureholders nine years before the final maturity date satisfied the requirement that the plan be fair and equitable.

(footnote continued on next page)

On appeal, the First Circuit rejected, in total, the reasons offered by the district court for denying post-petition interest to both classes of debentureholders. The court of appeals determined that while state law determines what *pre-petition* interest is allowable, federal law—not state law—determines whether *post-petition* interest on an allowable claim is to be paid by a solvent debtor's estate (15a). In accordance with the "fair and equitable" rule of the Bankruptcy Act, the court of appeals determined that the debentureholders were entitled to full compensation, including post-petition interest, on *all* components of their claims,[11] including unpaid pre-petition and post-petition installments of interest.[12] In so holding, the First Circuit confirmed the long-standing principle of bankruptcy law that if a debtor's estate is solvent, creditors have a right to be fully compensated on all elements of their claims before any payment is made to stockholders (*i.e.*, the petitioners).

In ruling that accelerated payment of the principal, as provided in the Plan, would compensate all debentureholders for the debtor's use of all of their funds, the district court apparently ignored the fact that the debentureholders were entitled to accelerate payment of the principal amount of their debentures as early as 1974, when CIC initially defaulted. Had the CIC reorganization proceedings not intervened, the debentureholders could then have obtained a judgment on their outstanding principal and accrued interest claims, and received interest on that *entire* judgment at the prevailing legal rate.

11. In the absence of a provision fixing a valid contractual rate of interest to be allowed on a claim, the First Circuit determined that the appropriate measure for the claimants' loss of the use of their funds during the pendency of a bankruptcy case is the "legal" or "judgment" rate of interest, 8 percent. That is the rate of interest accorded to the claims of other unsecured creditors whose claims had no agreed-upon rate of interest.

12. The First Circuit also rejected the district court's conclusion that payment of the principal of the debentures in advance of the due date might function as surrogate compensation in lieu of post-petition interest. The court noted that upon CIC's default in paying interest the debentureholders became entitled to accelerate payment of the principal. Thus, the payout of principal of the debentures gave the debentureholders no right which they did not already have.

NO REASON EXISTS FOR THE ISSUANCE OF A WRIT OF CERTIORARI

I.

THE COURT OF APPEALS FOLLOWED THE WELL-SETTLED RULE THAT FEDERAL BANKRUPTCY LAW, NOT STATE LAW, DETERMINES WHETHER POST-PETITION INTEREST IS TO BE AWARDED.

The entire premise of the Petition is that state law, not federal bankruptcy law, determines whether creditors are entitled to post-petition interest on their claims. That premise is wrong: under the Bankruptcy Act, state law has nothing to do with this question.[13]

This Court held in *Vanston Bondholders Protective Committee* v. *Green*, 329 U.S. 156, 161, 163 (1946), *reh. denied*, 329 U.S. 833 (1947), that while state law determines whether or not there is a valid pre-petition claim against the debtor which may be allowed in a bankruptcy case, *federal* law determines whether post-petition interest will be allowed on that claim:

> What claims of creditors are valid and subsisting obligations against the bankrupt at the time a petition in bankruptcy is filed is a question which, in the absence of overruling federal law, is to be determined by reference to state law.
>
> • • •
>
> *When and under what circumstances federal courts will allow interest on claims against debtors' estates*

13. As discussed in Point III, *infra*, the new Bankruptcy Code reaffirms this principle by expressly stating that post-petition interest is to be paid on *all* allowed creditors' claims, if funds are available to do so.

> ***being administered by them has long been decided by federal law.*** (emphasis added).[14]

This Court *expressly rejected* the reasoning of the Sixth Circuit in that case below, which, like petitioners in this case, thought that the recoverability of post-petition interest was a question of state law;[15] and it also did not accept the analysis of Justice Frankfurter's concurrence, cited frequently by petitioners here, to the same effect.

Petitioners—not the court of appeals below—seek to tamper with this rule by arguing, in the teeth of the clear language of *Vanston*, that state law, not federal law, controls on the question of whether post-petition interest may be allowed. *No* decision of this Court has superseded

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14. This principle was recently reiterated in *In re Marx*, CCH Bankr. Rep. ¶ 68,250, pp. 79,435, 79,437 (S.D. Ohio 1981):

> The subject of the allowance of post-petition interest is, in the final analysis, governed by the equitable principles of bankruptcy administration rather than the validity of such an interest claim under state law. The necessary and inherent power of a bankruptcy court to determine how a debtor's assets shall be distributed is paramount on the subject of post-petition interest.

The principle that "the manner in which the rights of debtors and creditors are adjusted [is a] matter of federal law" was recently reaffirmed by this Court in *Northern Pipeline Construction Co.* v. *Marathon Pipeline Co.*, 50 U.S.L.W. 4892, 4901 n.36 (U.S. June 28, 1982).

15. This Court stated:

> The Circuit Court of Appeals thought the bankruptcy court must allow or disallow the claim for [post-petition] interest on interest according to whether the covenant to pay it was valid or invalid [under state law]. . . .
>
> We agree with the conclusion of the Circuit Court of Appeals that the claim for interest on interest should not be permitted to share in the debtor's assets, *but disagree with the reasons given for that conclusion.*

Id. at 160-61 (emphasis added). In fact the Sixth Circuit had denied interest on interest for the same reason advanced by petitioners here: the fact that New York (and other) state laws did not permit it. The Court held that state law is irrelevant.

Vanston by holding that post-petition interest may not be granted by a bankruptcy court because state law does not permit it. This Court should not grant certiorari in order to entertain petitioners' attempt to overturn *Vanston* and replace in its stead a two-step test under which post-petition interest *must* always be denied where state law would invalidate an agreement between the parties to pay such interest.

Petitioners claim to find an inconsistency between the decision below and the decision of this Court in a pre-*Vanston* case, *Ecker* v. *Western Pacific Railroad Corp.*, 318 U.S. 448 (1943) (Pet. at 11). But *Ecker* contains no discussion whatsoever of whether federal or state law determines the availability of post-petition interest. Petitioners do not even point to any discussion or holding by the Court in that case; rather, they appear to rely solely upon a chart set out at page 445 of that opinion, which indicates that the plan of reorganization provided for (both pre- and post-petition) interest at the contract rate for a series of creditors. One senior creditor (R.F.C.) had advanced $10,000,000 to the debtor *after* the petition in bankruptcy had been filed (*id.* at 485), and had received in exchange a *non-interest-bearing* Trustee's certificate. In other words, R.F.C. had agreed to ask for no post-petition interest (in exchange for which its loan received priority over all other debts of the debtor). The fact that the plan of reorganization awarded no post-petition interest to R.F.C. under such circumstances indicates only an adherence to the parties' agreement that there would be no such interest—and not any *inability* of the court to award interest in other circumstances.

Petitioners' discussion of *Ecker* reflects their confusion of the *right* to interest with the *rate* of interest. In *Ecker*, as in other cases,[16] the courts, having determined that there is a *right* to interest, have taken the applicable *rate* from the parties' agreement. But it does not follow that, in the absence of an enforceable agreement setting such a *rate*, there is therefore no *right* to interest at all. Rather, in such cases courts have awarded interest at the applicable "legal" rate. *See In re Lum*, 1 B.R. 186, 188 (E.D. Tenn. 1979); *In re Imperial "400" National, Inc., supra*, 374 F. Supp. at 954. That is precisely what the district court did in this case for the benefit of CIC's other creditors whose claims bore no contractual rate of interest.[17]

Petitioners also assert that the decision below is inconsistent with cases in which the courts have allegedly looked to state law in deciding whether and how much post-petition interest is to be paid to creditors whose collateral is sufficient to cover both the claim and post-petition interest (Pet. at 10-11 and n. 12). No such inconsistency exists, because petitioners' cases do not stand for that proposition. For example, in *Coder* v. *Arts*, 213 U.S. 223, 245 (1909), after deciding that the mortgage in question was not a voidable preference under the Bankruptcy Act, this Court, in its *only* reference to the question of recoverability of interest on the claim, made no reference at all to state law:

> Nor do we think the Circuit Court of Appeals erred in holding that inasmuch as the estate was ample for that

16. *See, e.g., Ruskin* v. *Griffiths*, 269 F.2d 827, 830-832 (2d Cir. 1959), *cert. denied*, 361 U.S. 947 (1960); *In re Maryvale Community Hospital*, 156 F.2d 410, 413 (9th Cir.), *cert. denied*, 409 U.S. 879 (1972); and *In re Imperial "400" National, Inc.*, 374 F. Supp. 949, 954 (D.N.J. 1974).

17. And that is what section 726(a)(5) of the new Bankruptcy Code does.

purpose, Arts was entitled to interest on his mortgage debt.[18]

Ticonic National Bank v. *Sprague*, 303 U.S. 406 (1938), also cited by petitioners for the proposition that this Court felt bound by state law, in fact flatly contradicts that theory. In *Ticonic* this Court granted certiorari to resolve a conflict among the circuits on the question of whether secured creditors of a debtor bank were entitled to post-petition interest on their claims. The rule set down by *Ticonic* was a uniform one: secured creditors *are* entitled to such interest where their security is sufficient to cover it. *Id.* at 413. No uniform rule would have been possible if this Court had concluded that the issue was governed by state law.

The decision below is also not inconsistent with other decisions interpreting the right to enforce usurious loans in bankruptcy court, and, in particular, with *Speare* v. *Consolidated Assets Corp.*, 367 F.2d 208 (2d Cir. 1966) (Pet. at 11). There is nothing in *Speare* to indicate that the creditor was seeking post-petition interest at all. Rather, *Speare* deals with the question of whether the lender was entitled to *any* interest on a usurious loan (or even to a return of its principal)—a question which, under the first prong of the *Vanston* test (*i.e.*, the determination of whether a claim arises at all), is a question of state law.

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18. Similarly, neither *Palo Alto Mutual Savings & Loan Ass'n* v. *Williams*, 245 F.2d 77, 79 (9th Cir. 1957), nor *Eddy* v. *Prudence Bonds Corp.*, 165 F.2d 157 (2d Cir. 1947), *cert. denied*, 333 U.S. 845 (1948), cited by petitioners, even mentioned, much less relied upon, state law in determining that post-petition interest was allowable.

Finally, petitioners assert that the decision below conflicts with the Second Circuit's decisions in *Empire Trust Co.* v. *Equitable Office Building Corp.*, 167 F.2d 346 (2d Cir. 1948) and *In re Realty Associates Securities Corp.*, 163 F.2d 387 (2d Cir.), *cert. denied*, 332 U.S. 836 (1947). Although neither of those decisions discussed the distinction between pre- and post-petition interest on claims, it appears that the Second Circuit did rely upon state law in refusing to allow post-petition interest on claims for unpaid interest.[19] However, that is not the approach which has subsequently been followed in the Second Circuit. In *Ruskin* v. *Griffiths*, *supra*, 269 F.2d at 830, that court enforced a provision in the claimant's note for an increase in the rate of interest in the event of bankruptcy—a provision which the court assumed was equivalent to an agreement to pay interest on interest. In so doing it relied upon equitable principles of *federal* law, and never once mentioned the question of whether the agreement was valid under state law. Similarly, in *Corbin* v. *Federal Reserve Bank of New York*, 629 F.2d 233, 237-38 (2d Cir. 1980), *cert. denied*, 450 U.S. 970 (1981), a case under the National Bank Act where the creditor sought to enforce a post-insolvency-loan agreement providing for "interest on interest", the court once again ignored state law. In discussing whether the awarding of such interest would be fair under the principles of *Vanston*, the court found *Realty Associates* and *Empire Trust* to be irrelevant:

> None of the Second Circuit cases cited by the Trustee of FNYC extends *Vanston* to this kind of case. In *In*

19. However, in *Realty Associates* the Chapter X reorganization case had been dismissed, so the court was not faced with the question of whether the reorganization plan was "fair and equitable".

> *re Realty Associates Securities Corp.*, the court simply enforced interest provisions of the bond indenture refusing to alter them by substituting a judgment return of interest or compound interest.
>
> • • •
>
> In *Empire Trust* the court merely held that the indenture provisions for the payment of interest on interest were invalid under New York law. (citations omitted).

Thus, the Second Circuit does *not* currently adhere to petitioners' view of the talismanic significance of state law, and the law of the two circuits is therefore not in conflict on this point.

Moreover, even if we assume that *Empire Trust* and *Realty Associates* still have continuing vitality in the Second Circuit, the existence of a conflict with two thirty-year-old decisions of one other circuit court does not warrant the grant of certiorari here. *Empire Trust* and *Realty Associates* were incorrect in ignoring the clear rule of *Vanston* that the right to post-petition interest is governed by federal, not state law. These are half-forgotten decisions (not even cited for this proposition by petitioners in the court below), old curiosities well outside of the mainstream of subsequent opinion even in their own circuit. Certiorari is certainly not needed to reaffirm the teaching of *Vanston* or to reject the reasoning of two isolated, obsolete decisions, especially because (as discussed in Point III), the Bankruptcy Code squarely rejects the holdings of *Empire Trust* and *Realty Associates* and thereby eliminates any possibility of confusion on this point in the future.

II.

THE COURT OF APPEALS ALSO FOLLOWED THE WELL-SETTLED RULE THAT WHERE THE DEBTOR IS SOLVENT THE BANKRUPTCY ACT REQUIRES THE PAYMENT TO CREDITORS OF FULL COMPENSATION, INCLUDING POST-PETITION INTEREST, BEFORE STOCKHOLDERS MAY RECEIVE ANY DISTRIBUTION FROM THE ESTATE.

A. The Rule Is Clear.

In determining whether post-petition interest should be awarded to creditors, the district court must look to the "fair and equitable" test of the Bankruptcy Act—not to state law.[20] Where the debtor is solvent, that test has been consistently construed to require that creditors must receive post-petition interest on *all* allowed claims before stockholders may receive any distributions from the estate.

In *Case* v. *Los Angeles Lumber Products Co.*, 308 U.S. 106, *reh. denied*, 308 U.S. 637 (1939), this Court expressly held that a plan of reorganization under Chapter X must meet the strict standards of the "absolute priority" rule set forth in *Northern Pacific Railway* v. *Boyd*, 228 U.S. 482 (1913) in order to satisfy the statutory "fair and equitable" rule. The absolute priority rule requires that senior creditors must be paid *in full* before junior creditors receive anything. *Consolidated Rock Products* v. *DuBois*, 312 U.S. 510 (1941); *SEC* v. *American Trailer Rentals*, 379 U.S. 594

20. Article VII, Section 174 of the Bankruptcy Act, 11 U.S.C. § 574, states that the district court shall approve the plan of reorganization under Chapter X only if it is "fair and equitable"; and Article XI, Section 221, 11 U.S.C. § 621, provides that the judge shall confirm a plan only if it is "fair and equitable".

(1965). The "absolute priority" rule also provides that, when a Chapter X estate is solvent, interest on a claim must receive the same priority in distribution as the underlying claim. As succinctly stated in 6 Collier pt. II, *Bankruptcy* ¶ 9.08 at 1570, 1583 (14th ed. 1978), the absolute priority rule

> demands that creditors of each class receive full compensatory treatment for the entire bundle of rights they surrender. Interest on a claim to the date of payment is one of such rights. Where the plan provides for payment in full, interest to the date of payment would seem essential before anything is turned back to the debtor or its stockholders. To return assets without providing for the payment of such interest would certainly seem to do violence to the "absolute priority" rule.

This language was quoted with approval in *In re Imperial "400" National Inc., supra,* 374 F. Supp. at 953-54. This principle was also recognized in *Vanston,* where the Court stated that

> where an estate was ample to pay all creditors and to pay interest even after the petition was filed, equitable considerations were invoked to permit payment of this additional interest to the secured creditor rather than to the debtor. 329 U.S. at 164 (citations omitted).[21]

In accordance with this principle, there is a general rule that post-petition interest on creditors' claims is to be allowed when the debtor is solvent. *In re Maryvale Com-*

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21. That rule was not applied in *Vanston* itself because the debtor was *insolvent*; therefore, any award of post-petition interest to a senior creditor would have injured junior creditors. In such a case the absolute priority rule was held not to require payment of post-petition interest. But that principle does not apply where the only parties who would be "injured" by an award of post-petition interest would be stockholders. *See Raskin* v. *Griffiths, supra,* 269 F.2d at 831.

munity Hospital, Inc., 456 F.2d 410, 413 (9th Cir.), *cert. denied*, 409 U.S. 879 (1972); *Ruskin* v. *Griffiths*, *supra*, 269 F.2d at 830; *In re Imperial "400" National, Inc.*, *supra*, 374 F. Supp. at 953; *In re International Hydro-Electric System*, 101 F. Supp. 222 (D. Mass. 1951). *See also United States* v. *Bass*, 271 F.2d 129, 130 (9th Cir. 1959); *Mortgage Loan Co.* v. *Livingston*, 78 F.2d 517, 521 (8th Cir.), *cert. denied*, 296 U.S. 607 (1935); and *City of New York* v. *Saper*, 336 U.S. 328, 330 n.7 (1949).[22]

Petitioners have conceded that the debentureholders had a right to payment of post-petition interest on the principal amount of their claim—*i.e.*, to payment of installments of interest on the debentures which fell due after the petition was filed—and the reorganization plan so provided. There is, of course, overwhelming support for the debentureholders' right to such "simple" post-petition interest in a solvent case. *See, e.g., Consolidated Rock Products* v. *DuBois*, *supra*, 312 U.S. at 515 n.4, 529, where Justice Douglas, writing for the Court, stated that under the absolute priority rule, accrued interest on bonds was "entitled to the same priority as the principal", and that any effort to infringe upon such right for the benefit of stockholders "comes within the judicial denunciation". Petitioners nonetheless seek to draw a distinction between post-petition interest on principal, which they concede is allowable, and post-petition interest on the accrued interest, which they claim is not allowable.

No such distinction exists. What petitioners fail to recognize is that bankruptcy courts grant post-petition in-

22. While in some of these cases the creditors had a contractual right to interest (*see* Pet. at 8-12), as noted above, even where there is no agreement for interest the court may award interest at the legal rate.

terest on *claims*, which in this case included claims for unpaid installments of interest. There is no reason for treating the interest portion of a claim any differently from the principal portion of that claim; for, under Chapter X of the Bankruptcy Act, all types of claims, of whatever character, receive equal treatment, including the principal and accrued interest components of a claim.[23] Therefore, *each* component of that claim, including the claim for interest, must be fully compensated in accordance with the fair and equitable rule.[24] Thus, because the CIC estate is solvent, the Court of Appeals followed well-settled rules in holding that all creditors, including the debentureholders, are entitled to receive post-petition interest in compensation for their *entire* claim.

Petitioners contend that the absolute priority rule does not create a right to post-petition interest and that such a right must be predicated upon state law (Pet. at 12-16). For this they place principal reliance upon *Vanston* and *Ecker*, which, as we have demonstrated above, do not support such a proposition. In addition, they rely upon *In re New York, New Haven and Hartford Railroad*, 4 B.R. 758, 799 (D. Conn. 1980) (Pet. at 14), for the proposition that the absolute priority rule does not determinate what interest is

23. Under Section 106(4) of the Bankruptcy Act, claims are defined to include "all claims of whatever character . . . whether secured or unsecured, liquidated or unliquidated, fixed or contingent." As stated in 6 Collier pt. I, *supra*, ¶ 2.05 at 306, this definition is "sweeping in scope", is "a more inclusive definition than that applicable in ordinary bankruptcy, and it should be given a broad construction." *See In re Stirling Homex Corp.*, 579 F.2d 206, 212 (2d Cir. 1978), *cert. denied*, 439 U.S. 1074 (1979).

24. This principle, as well as the right of creditors to receive post-petition interest when an estate is solvent, is embodied in provisions of the Bankruptcy Code. *See* Code sections 502, 726 and 1129, 11 U.S.C. §§ 502, 726 and 1129.

allowable. However, in that case the court expressly followed the rule petitioners say does not exist:

> [I]f the bankrupt is solvent and there is a surplus after payment of all claims, creditors should receive interest on their interest-bearing claims rather than having the surplus turned over to the debtor [*i.e.*, stockholders]. 4 B.R. at 798.[25]

There is no mystery as to why the "fair and equitable" rule requires payment of post-petition interest on *all* of the debentureholders' claims: CIC has detained millions of dollars of the debentureholders' funds during the five years this reorganization case was pending. Had CIC not elected to file a voluntary petition under the Bankruptcy Act the debentureholders could have obtained a judgment for the *entire* amount of their debt, including the accrued interest portion, and would have received interest from the date of entry of that judgment.[26] The filing of the petition prevented the entry of such a judgment. Where the estate is solvent, there is no reason to allow the debtor to use the reorganization case to shield itself from the obligation to pay interest *which it is fully able to pay*, and would have been required to pay but for the institution of those proceedings. In short, the First Circuit correctly recognized that there is no reason to allow a solvent debtor, such as CIC here, the free use for up to five years of $23 million of the debentureholders' money—the unpaid interest installments—where the debtor is fully able to pay for the use of that money.

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25. In determining whether to award post-petition interest the court followed federal bankruptcy law, not state law. Thus, secured creditors whose collateral was sufficient to cover post-petition interest received it; others did not because the estate was insolvent and, under *Vanston*, post-petition interest was not awardable because it would have reduced the recovery of junior creditors.

26. Where a judgment is obtained, "interest upon interest" is permitted under New York law. *See* note 34 *infra*.

B. The First Circuit's Application of the Fair and Equitable Rule Does Not Conflict With This Court's Decision in *Butner*.

Petitioners assert that there can be no federal bankruptcy rule permitting post-petition interest on claims for unpaid interest, because such a rule allegedly conflicts with this Court's decision in *Butner* v. *United States*, 440 U.S. 48 (1979) (Pet. at 20-21). Not so.

Butner holds that state real property law determines whether a mortgagee who has not foreclosed is entitled to receive the rents payable on the mortgaged property during a bankruptcy case. But in that case this Court repeatedly emphasized that state law must control only because Congress had not fashioned a federal rule defining a mortgagee's interest in rents, and that, had Congress done so, its rule would control:

> Property interests are created and defined by state law. *Unless some federal interest requires a different result*, there is no reason why such interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding (emphasis added). 440 U.S. at 55.

Butner does not conflict with the decision below because here, unlike in *Butner*, Congress *has* created a "federal rule" applicable to this case: the statutory "fair and equitable" rule for distributions to claimants under Chapter X, which requires the payment of post-petition interest on claims against a solvent estate. Because there *is* a Congressional mandate here, the First Circuit quite properly followed it.

C. Post-Petition Interest Was Properly Awarded on All Unpaid Installments of Interest.

Point II of the Petition asserts a "fall-back" position that, even if there is a bankruptcy rule requiring a solvent debtor to pay interest on *all* claims, that rule cannot apply to claims for interest which accrued after the filing of the petition. Making a series of technical arguments, petitioners would preclude the bankruptcy courts from awarding post-petition interest with respect to interest installments which accrued after a reorganization case was filed. None of these arguments has any merit; and none comes even close to raising an issue which might warrant the grant of certiorari.

First, petitioners assert that such an award cannot be made because the debentureholders' original proof of claim did not include a claim for installments of simple interest not owing at the time of the filing of the petition. This argument is incorrect because (a) the court of appeals did not construe the debentureholders' claims as being so limited (13a n.5, 16a); (b) the right to post-petition interest on a claim is a statutory right for which no separate proof of claim must be filed; and (c) in 1976, when the petition and the debentureholders' proofs of claim were filed, no one could have predicted whether the debtor would turn out to be solvent. Petitioners forget that the district court *did* award the debentureholders their post-petition simple interest installments; petitioners never objected on the ground that such post-petition installments could not be awarded because the debentureholders did not ask for them in their proof of claim.

Next, petitioners argue that any award of post-petition interest is barred by Section 63a of the Bankruptcy Act, 11 U.S.C. § 103, which prohibits the allowance of claims for unmatured interest. But Section 63 of the Bankruptcy Act is not applicable to a Chapter X case, as petitioners themselves concede (Pet. at 18 n.29). Under Section 106(1) of the Act, 11 U.S.C. § 506(1), the definition of a claim in Chapter X includes claims "not provable under Section 63."[27] Even the Trustee, in his brief (pp. 4-5) supporting the Petition herein, concedes that under Chapter X creditors are to receive interest *to the date of payment.*

Finally, petitioners claim that the First Circuit's award of post-petition interest on post-petition interest is not supported by any precedent. Petitioners have the argument backwards. The debentureholders' claim properly included all pre-petition and post-petition installments of simple interest; it therefore follows that there is no distinction between pre-petition and post-petition claims in determining whether post-petition interest on those claims should be allowed. In the absence of any contrary authority—and petitioners have cited none—the court of appeals made no error here.

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27. *See* note 23, *supra*. Definitions embodied in section 502(b) of the Bankruptcy Code also are not controlling here. *See* Bankruptcy Reform Act of 1978, § 403(a), *supra* note 5.

III.

THE ISSUES RAISED IN THE PETITION ARE MOOTED BY THE NEW BANKRUPTCY CODE.

Although the decision below was clearly correct under the Bankruptcy Act, even if there were some doubt on this score, certiorari would still not be warranted because the new Bankruptcy Code, which governs all bankruptcy cases commenced after September 30, 1979, unequivocally requires that solvent debtors pay post-petition interest on *all* claims. Thus, the question of whether the old Act also provides for such interest in the "dwindling number" of cases governed by the Act[28] will be of little consequence in the future, and is not the type of pressing issue which warrants examination by this Court.

Chapter 11 of the new Code governs reorganizations such as CIC's. Under section 1129(a)(7)(A)(ii) of chapter 11, a reorganization plan may be confirmed only if each creditor receives no less than he would have received in a chapter 7 liquidation. The relevant liquidation provision, section 726, entitled "distribution of property of the estate", sets forth rules of priority for distributions from the estate. The first four priorities include unsecured and secured claims. The fifth priority (superior to any right of the debtor to receive anything) is

> payment of interest at the legal rate from the date of the filing of the petition, on any claim paid. . . . Code section 726(a)(5).

Thus, where the estate has sufficient funds to pay such interest, Congress has *expressly required* the payment of

28. *See* the Trustee's brief in support of the Petition, pp. 2-3.

interest on *all* claims in chapter 7 (and therefore chapter 11) cases—*regardless* of whether there is any agreement providing for payment of such interest, and *regardless* of state law. As summarized in a recent commentary, under the Code

> If an estate is solvent, before the debtor is entitled to retain any property of the estate, creditors are required to receive post-petition interest in an amount computed at the "legal rate".[29]

Nor is there any doubt that under the Code the claims upon which post-petition interest *must* be allowed include claims for unpaid interest. Section 726 provides for payment of any "allowed unsecured claims";[30] and "claim" is defined by the Code (section 101(4)) to include *any* right to payment.[31] That this sweeping definition includes claims for interest is crystal clear from the legislative history:

> a right to payment for interest due is a right to payment which is within the definition of "claim" in section 101(4). . . .

Statement of the Legislative Leaders (House) 124 Cong. Rec. H 11,098 (daily ed. Sept. 28, 1978); (Senate) S 17,415 (daily ed. Oct. 6, 1978).[32]

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29. *Fortgang and King*, "The 1978 Bankruptcy Code: Some Wrong Policy Decisions", 56 N.Y.U.L. Rev. 1148, 1151 (1981). The Trustee, in his brief supporting the Petition, ignores this point while arguing that the Bankruptcy Code does not affect the issues raised in the Petition.

30. *See* section 726(a)(2).

31. Section 101(4)(A) defines "claim" to include

> right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, secured or unsecured . . . .

32. This is an excerpt from both the Senate and House reports on the final version of the Bankruptcy Code. It is quoted in Part 3, Collier *Bankruptcy Code* (1977 Pamphlet Ed. p. 341).

In short, the decision of the First Circuit in this case will be of very little relevance to the future administration of reorganization cases: it applies only to cases to be decided under the old Act, and it applies only where the debtor's estate is solvent—not an everyday occurrence by any means.[33]

IV.

THE DECISION OF THE COURT OF APPEALS WILL NOT AFFECT THE COMMERCIAL LAWS OF THE VARIOUS STATES.

We have demonstrated above that, under *Vanston*, state law does not control the determination of whether post-petition interest will be granted. In following this rule, the decision below will have no impact on the interaction between the laws of the states and the Bankruptcy Act. We also have demonstrated that the new Code on its face requires the payment of interest regardless of state law. Thus, petitioners' argument that the decision below will "render meaningless" state laws governing agreements for the payment of interest on interest, as well as state laws barring creditors with usurious contracts from collecting

33. In his brief in support of the Petition the Trustee laments that the court of appeals' decision has allegedly adversely affected stockholders in another case, *Continental Mortgage Investors*, No. 76-593-S (D. Mass.) (*"CMI"*), because the district court therein has construed the court of appeals' decision in this case to require post-petition interest to be computed at the legal rate, rather than the (lower) contractual rate. The fact that the decision below (purportedly) has been followed in one subsequent case is hardly startling. Nor is it surprising that application of the decision below would take money out of the hands of stockholders in order to fully compensate creditors. How that fact supports the granting of certiorari here is a mystery.

We express no view as to whether the district court in *CMI* correctly followed the First Circuit decision in this case. That question is not before this Court.

interest (Pet. at 25-26), is empty rhetoric. The decision here applies only in cases brought under the old Bankruptcy Act where the debtor turns out to be solvent. State law will surely survive such a microscopic "exception".[34]

But, petitioners argue, the opinion of the court below will invite creditors to commence cases under the Bankruptcy Code to improve their private contractual rights (Pet. at 26-29). This argument is a *non sequitur*, because the Code (which governs any reorganization case that might be filed now) expressly requires the universal payment of post-petition interest by solvent debtors, and will continue to do so, regardless of whether the decision below stands or falls. Moreover, this argument totally disregards the inherent delay attendant to bankruptcy and reorganization cases, and the Bankruptcy Code's protections to debtors against ill-founded involuntary petitions,[35] which

34. Under New York law interest on a judgment is allowed, as a matter of right, "upon the total sum awarded, including interest to verdict". N.Y. Civ. Prac. Law § 5002 (McKinney 1963 & Supp. 1964-81). Moreover, even pre-judgment interest on claims for interest may sometimes be awarded. *See, e.g., City of New York* v. *State of New York*, 95 Misc. 2d 810, 815-18, 408 N.Y.S. 2d 702, 704-07 (Ct. Cl. 1978) and cases cited therein.

35. *See* section 303 of the Bankruptcy Code, 11 U.S.C. § 303. Section 303(h) of the Code limits the basis for involuntary relief to (i) the debtor's general inability to pay debts as they become due, and (ii) the appointment of a "custodian" to take charge of substantially all of the debtor's property within 120 days preceding the petition. 11 U.S.C. § 303(h). Section 303(i) of the Bankruptcy Code gives the court the power to award costs, reasonable attorney's fees or "any damages proximately caused by the taking of possession of the debtor's property by a trustee" when an involuntary petition is dismissed after trial. Finally, under subsection (i)(2), if the court finds that a petition was filed in "bad faith" the court also may award the debtor "punitive damages" or "any damages proximately caused by such filing." 11 U.S.C. § 303(i)(2). Because a petitioning creditor is liable if a petition is ultimately dismissed, it is highly unlikely that a creditor would commence a case under the Bankruptcy Code merely to improve his contractual rights if the debtor is not otherwise eligible for relief.

together make it highly improbable that creditors would be tempted to try to misuse the bankruptcy courts to "improve" their rights. In fact, it is far more likely that if petitioners had their way and state law were to be controlling in the future, solvent debtors might voluntarily seek refuge in the bankruptcy courts to prevent their creditors from entering judgments against them which would then bear interest upon interest. Thereby debtors could obtain a "free ride", at their creditors' expense, for the duration of the case—which is exactly what petitioners are attempting to accomplish in this case.

In awarding debentureholders full compensation for the surrender of their claims, the First Circuit, rather than disrupting commercial law, actually was applying a fundamental principle of the commercial marketplace, which allocates the risk of investment in a failing company to stockholders rather than creditors. As expressed by the Second Circuit in *In re Stirling Homex Corp.*, 579 F.2d 206, 213-14 (2d Cir. 1978), *cert. denied*, 439 U.S. 1074 (1979):

> When persons or institutions lend money to a corporation, or otherwise become its creditors, they do so in reliance upon the protection and security provided by the money invested by the corporation's stockholders—the so-called "equity cushion". . . . Credit is given to corporations with little or no knowledge of names of stockholders, but with confidence that, whoever they are, their rights in and to corporate property are subordinate to the rights of creditors.[36]

36. *Accord, F.D.I.C.* v. *American Bank Trust Shares, Inc.*, 412 F. Supp. 302, 308 (D.S.C. 1976), *vacated on other grounds*, 558 F.2d 711 (4th Cir. 1977); *Scott* v. *DeWeese*, 181 U.S. 202 (1901); *Sanger* v. *Upton*, 91 U.S. [1 Otto] 56, 60 (1875); *Carter* v. *Bogden*, 13 F.2d 90, 93-94 (8th Cir. 1926); *Scott* v. *Abbott*, 160 F. 573 (8th Cir.), *cert. denied*, 212 U.S. 571 (1908).

In short, the court of appeals' narrow holding will neither impair the enforcement of state commercial law, nor increase the filing of involuntary petitions under the Bankruptcy Code.

CONCLUSION

For the reasons stated above, the petition for a writ of certiorari should be denied.

Respectfully submitted,

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No. 88-1918

In the

Supreme Court of the United States

October Term, 1988

GLEN CORPORATION, ET AL.,
Petitioners,

v.

O.C. ASSOCIATES, ET AL.,
Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS
FOR THE FIRST CIRCUIT.

BRIEF OF DEBENTUREHOLDERS
PROTECTIVE COMMITTEE IN OPPOSITION.

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Question Presented.

Where a debtor is found to be solvent, does federal bankruptcy law require that creditors be paid interest on the full amount of their claims?

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In the
Supreme Court of the United States

OCTOBER TERM, 1982.

No. 82-106

GLEN CORPORATION, ET AL.,
PETITIONERS,

v.

O.C. ASSOCIATES, ET AL.,
RESPONDENTS.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT.

BRIEF OF DEBENTUREHOLDERS PROTECTIVE COMMITTEE IN OPPOSITION.

Respondent Debentureholders Protective Committee (the "Committee") hereby opposes the petition for a writ of certiorari filed by Glen Corporation, Monte J. Wallace, Neil W. Wallace and the Minority Stockholders' Committee of Continental Investment Corporation in this case.

Statement of the Case.

In April 1973, Continental Investment Corporation ("CIC") offered an issue of straight debentures due on November 1, 1985 (the "straight debentures") in exchange for then outstanding convertible debentures due on November 1, 1990 (the "convertible debentures"). Both the straight debentures and the convertible debentures bore interest at the rate of nine percent per annum and the trust indenture for both the straight debentures and the convertible debentures provided that upon default in the payment of any installment of interest, CIC would pay interest on the overdue installments at the rate of interest borne by the debentures, to the extent permitted by law. (P-3a, 4a.)[1] The straight debentures were, by their terms, deemed to be contracts made under the laws of the State of New York; the convertible debentures were, by their terms, deemed to be contracts made under the laws of the Commonwealth of Massachusetts. *Id.* CIC defaulted on the interest payments due on the debentures on November 1, 1974 and, except as described below, made no interest payments thereafter. (P-4a.)

On April 30, 1976, CIC filed a petition under Chapter XI of the Bankruptcy Act and the proceeding was thereafter converted to a Chapter X proceeding in the United States District Court for the District of Massachusetts.

On June 5, 1981 the Trustee in bankruptcy proposed a Third Modified Plan of Reorganization (the "Trustee's Plan"). As of that date, and thereafter, CIC was a solvent corporation. (P-6a.) The Trustee's Plan provided that holders of straight debentures and convertible debentures would receive the principal amount of the debentures plus all overdue installments of

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[1] References to material in the appendix to the Petition are denoted "P-1a", etc. References to material in the Petition are denoted "P-1", etc.

interest but did not explicitly provide for the payment of any amount on account of interest on the overdue installments. (P-5a, 18a.) On June 18, 1981, the district court approved the Trustee's Plan for submission to stockholders of CIC,[2] however, in ruling on the Trustee's Plan, the district court noted that all parties had agreed to defer the interest on overdue interest issue to some later date. (P-18a.) All parties thereafter submitted memoranda on the issue and, on September 9, 1981, the district court entered a memorandum and order denying the claims of holders of straight and convertible debentures to interest on overdue installments of interest. (P-17a.) The committee duly perfected its appeal from that order. On September 16, 1981, the district court confirmed the Trustee's Plan.

In its appeal to the United States Court of Appeals for the First Circuit (the "Court of Appeals") the Committee argued that the interest on interest provisions of the straight debentures were enforceable in a manner consistent with the express public policy of the State of New York,[3] and that in any case the absolute priority rule required the payment of interest on overdue interest even if not accrued at the contract rate.[4]

The Court of Appeals held that holders of convertible debentures were entitled to interest at the contract rate on all unpaid installments of interest under the laws of the Commonwealth of Massachusetts and that, absent payment of such interest, the Trustee's Plan was not fair and equitable. (P-14a.)[5]

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[2] The district court determined that because CIC creditors were not affected by the Trustee's Plan, that is, they received all to which they were entitled, they were not eligible to vote on the Trustee's Plan.

[3] Brief of Debentureholders Protective Committee at 4-14, in 81-1741.

[4] *Id.* at 14-17. To the extent that the petitioners imply that the Committee made no claim to interest on overdue interest under federal law (*see* P-5, 6), the petitioners are wrong. (*See* P-18 n.28.)

[5] The petitioners have not sought a writ of certiorari with regard to this decision. (P-5 n.4.)

With regard to the straight debentures, the Court of Appeals held that New York law precluded a contractual right to interest on overdue interest and further precluded a non-contractual right to interest on overdue interest accrued prior to the commencement of the CIC Chapter XI proceeding.* (P-15a.) The Court of Appeals also held, however, that under federal bankruptcy law, straight debentureholders were entitled to interest from the commencement of the CIC Chapter XI proceeding at the statutory general rate of eight percent on all unpaid installments of interest. *Id.* Accordingly, the Court of Appeals reversed the decision of the district court.

Argument.

I. The Court of Appeals Properly Decided That There is a Right to Post-Petition Interest Under Federal Bankruptcy Law.

The petitioners raise a great hue and cry over the Court of Appeals' unremarkable statement that "[i]t is a general rule of federal bankruptcy law that if the alleged bankrupt proves solvent, creditors have a right to receive post-petition interest at the statutory general rate . . . before any surplus reverts to the debtor." (P-15a.) While the necessary predicate of the Court of Appeals' statement — a solvent debtor — is rarely encountered, where as here the debtor is solvent, creditors are entitled to be made whole before the stockholders of the debtor receive any distribution of the debtor's assets. As stated by this Court in *Consolidated Rock Products Co.* v. *Du Bois*, 312 U.S. 510 (1941), "'any arrangement of the parties by which the sub-

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*The Committee has not sought review of the Court of Appeals' decision on the effect of New York law and does not press the issue before this Court.

ordinate rights and interests of the stockholders are attempted to be secured at the expense of the prior rights' of creditors 'comes within judicial denunciation.'" *Id.* at 527 (quoting *Louisville Trust Co.* v. *Louisville, N.A. & C. Ry. Co.*, 174 U.S. 674, 684 (1899)).

A creditor's non-contractual right to receive interest on its claim does not arise from state law, although state law may be applied to determine the proper rate of interest, but rather from the absolute priority rule set down by this Court in *Northern Pacific R.R. Co.* v. *Boyd*, 228 U.S. 482 (1913) and reiterated in *Consolidated Rock Products, supra.* Even where claims do not bear a contractual rate of interest, the absolute priority rule requires that creditors holding such claims be allowed interest at the governing legal rate. *In re Imperial "400" National, Inc.*, 374 F. Supp. 949 (D. N.J. 1974); 6 *Collier on Bankruptcy* § 9.08, at 1583 (14th ed. 1978); *cf. Muskegon Motor Stockholders Protective Committee* v. *Davis* (In re Muskegan Motor Specialties), 366 F.2d 522, 529 (6th Cir. 1966) (in light of absolute priority rule, accrued interest at statutory rate must be added to creditors' claims to determine debtor's solvency).

The petitioners state, however, that creditors are entitled to interest only "if the creditor is otherwise entitled to interest under applicable non-bankruptcy law." (P-9.) This assertion is belied by *Imperial "400", supra*, and common sense. As noted by this Court in *Vanston Bondholders Protective Committee* v. *Green*, 329 U.S. 156 (1946), "[c]ourts have felt that it would be inequitable for anyone to gain an advantage or suffer a loss because of [the] delay" in payment caused by the commencement of bankruptcy proceedings. *Id.* at 164. The petitioners would permit a debtor to use and invest creditors' funds over a period of years and be liable only for the principal

amount of the creditors' claims, the interest or other income thereon to go to the debtor's stockholders.[7]

The Court of Appeals' decision did nothing more than make the straight debentureholders whole for the delay in payment caused by the imposition of the Chapter X proceeding. Had the debtor not sought protection under the bankruptcy law, the straight debentureholders would have received semi-annual payments of interest on outstanding principal. The Trustee's Plan offered the straight debentureholders only the principal amount of the debentures plus such interest as had accrued from November 1, 1974 through October 26, 1981. Under the Trustee's Plan, the straight debentureholders were not accorded any recognition or compensation for the detriment caused by the seven year delay in the payment of interest. Regardless of the straight debentureholder's right to interest on overdue interest under New York law, a right that the straight debentureholders do not press before this Court,[8] the straight debentureholders are entitled to be made whole before the debtor's stockholders share in any distribution. Payment of interest accrued over seven years in a lump sum, with no accounting made for the passage of time, does not make the straight debenture-

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[7] This type of inequitable treatment of creditors' claims was explicitly barred by the United States Congress in enacting the Bankruptcy Reform Act of 1978, 11 U.S.C. prec. 101 (Supp. II 1978) (the "Bankruptcy Code") the statutory successor to the Act under which the instant proceeding was commenced. Section 726(a)(5), (6) of the Bankruptcy Code (11 U.S.C. § 726(a)(5), (6)) provides that unsecured creditors in a Chapter 7 proceeding shall receive interest at the legal rate, from the date of the commencement of the proceeding, prior to any distribution to the debtor. The Chapter 11 reorganization provisions of the Bankruptcy Code incorporate this requirement and provide that the court cannot confirm a plan of reorganization unless all creditors in a class accept the plan or each creditor in the class will receive an amount equal to that which it would receive in a Chapter 7 proceeding. Bankruptcy Code § 1129(a)(7)(A) (11 U.S.C. § 1129(a)(7)(A).

[8] See note 6, *supra*.

holders whole. The Court of Appeals properly found that the trustee's plan was not fair and equitable and that straight debentureholders were entitled to interest on overdue installments of interest under federal bankruptcy law.

II. The Court of Appeals' Decision is Not in Conflict With the Decisions of This Court or the Decisions of the United States Court of Appeals for the Second Circuit.

A. Butner v. United States *Has no Bearing on the Issue before This Court.*

The Court of Appeals did not ignore state law in reaching its decision. The Court of Appeals explicitly rejected the claims asserted by the Committee under New York law (P-14a, 15a) and consequently held that straight debentureholders were not entitled to interest on overdue installments of interest at the contract rate of nine percent computed from the debtor's default in 1974. Rather, the Court of Appeals held that as a matter of federal law the straight debentureholders were entitled only to interest on overdue installments of interest at the statutory rate of eight percent computed from the commencement of the Chapter XI proceeding in 1976.

In *Butner* v. *United States*, 440 U.S. 48 (1979), this Court held that a mortgagee is not entitled to an automatic security interest in rents and profits under federal bankruptcy law where state law would deny such a security interest without some further action, for example foreclosure, by the mortgagee even where such action is barred by the debtor's bankruptcy. *Id.* at 56.

Butner is inapposite where, as here, the straight debentureholders are asserting a right, neither anticipated nor created by state law, to be compensated for the injury suffered by the intrusion of federal bankruptcy law. *Butner* goes no further

than to hold that, as between creditors of an insolvent estate, the relative priorities established by state law will be maintained under the bankruptcy law. Thus, a partially secured creditor cannot by claiming an "automatic" security interest improve its position over unsecured creditors by recourse to the bankruptcy courts. *Butner* does not hold that a bankruptcy court administering a solvent estate can ignore the mandate of the absolute priority rule to the detriment of creditors by ignoring the delayed satisfaction of a contractual right to interest.

B. *The Court of Appeals' Construction of* Vanston Bondholders Protective Committee *v.* Green *is Consistent With the Recent Decisions of the Second Circuit.*

The petitioners cite *In re Realty Associates Securities Corp.*, 163 F.2d 387 (2d Cir.), *cert. denied*, 332 U.S. 836 (1947) and *Empire Trust Co.* v. *Equitable Office Building Corp.*, 167 F.2d 346 (2d Cir. 1948) as evidence of a conflict between the First Circuit and Second Circuit Courts of Appeals over the issue of interest on overdue interest. That such a conflict might have arisen during the 1940's is possible but, as the petitioners note in a passing footnote, both *Realty Associates* and *Empire Trust* have since been distinguished by the Second Circuit.

In *Ruskin* v. *Griffiths*, 269 F.2d 827 (2d Cir. 1959), *cert. denied*, 361 U.S. 947 (1960), the Second Circuit reversed a district court's order disallowing a creditor's claim to an increased rate of interest after default. The district court had relied on the Court's decision in *Vanston*, *supra*. The Second Circuit stated:

> Even if we agreed with the court below that a Supreme Court precedent dealing with an obligation for interest on interest falling due because of an equity court's stay

> order is equally applicable to a claim based upon a contractual provision for additional simple interest arising because the debtor sought the intervention of the bankruptcy laws, a question we need not now decide, we would still have to distinguish *Vanston* on what we find was a basic ground of that decision. In *Vanston*, the debtor was insolvent, and in our case it appears the debtor is solvent. In *Empire Trust Co.* v. *Equitable Office Bldg. Corp.* . . ., we avoided a resolution of the effect of *Vanston* upon parties to a reorganization proceeding involving a solvent corporation, but the issue is squarely before us now, and we hold that the Supreme Court did not intend that the principle enunciated by it in *Vanston*, in a contest between creditors, should be applied to a contest between a debtor's creditor and its stockholders.

269 F.2d at 830 (citation omitted).

Significantly, the *Ruskin* court relied primarily on the dissenting opinion of Judge Clark in *Realty Associates, supra*, to support its construction of *Vanston*.

And in *Corbin* v. *Federal Reserve Bank of New York*, 629 F.2d 233 (2d Cir. 1980), *cert. denied*, 450 U.S. 970 (1981), the Second Circuit stated:

> In *Empire Trust Co.* v. *Equitable Office Bldg. Corp.* . . ., the court merely held that indenture provisions for the payment of interest on interest were invalid under New York law. And *Ruskin* v. *Griffiths* . . . enforced a contract providing for a post-default increase in interest, *even assuming that this was the equivalent of interest on interest* . . . because the estate was solvent.

629 F.2d at 238 (emphasis added).

Perhaps because of the paucity of solvent debtors, the Second Circuit's movement away from *Realty Associates* and *Empire Trust* has been episodic, but the movement is clear. Indeed, it is apparent from *Ruskin* that the Second Circuit would enforce a contractual interest on interest provision without reference to underlying state law, a step the First Circuit has refused to take.

The Court of Appeals' decision in this case, therefore, is neither unprecedented or in conflict with the decisions of the Second Circuit.

III. The Court of Appeals' Decision Will Not Encourage the Commencement of Additional Bankruptcy Proceedings.

The petitioners envision teems of secured creditors flooding into the bankruptcy courts to take the supposed advantageous position accorded them by the Court of Appeals' decision. Nothing is more implausible. No secured creditor would avoid foreclosing on the property of a *solvent* debtor and instead seek relief under the Bankruptcy Code, to be paid interest at the legal rate *only* to the extent that the creditor did not receive interest payments during the course of the proceeding and *only* if the debtor remained solvent for that period. Indeed, although the petitioners state that creditors whose contractual rate of interest is below the legal rate will avidly commence bankruptcy proceedings (P-27), if the debtor is in default such creditors could achieve the same result by commencing a civil collection proceeding. And if the debtor is not in default, the creditor has no grounds on which to commence a bankruptcy proceeding.

The Court of Appeals' decision affords relief only to creditors who, by the debtor's own acts, have been prevented from collecting the sums due them during the course of a bankruptcy proceeding where to deny relief would give an inequitable

benefit to the debtor or its stockholders. The decision of the Court of Appeals should be sustained and certiorari should be denied.

Conclusion.

The petition for a writ of certiorari should be denied.

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Supreme Court, U.S.
FILED
AUG 9 1982
CLERK

No. 82-108

In the

Supreme Court of the United States

October Term, 1981

CLEN CORPORATION, et al.,
PETITIONERS,

v.

O.C. ASSOCIATES, et al.,
RESPONDENTS.

MEMORANDUM OF PAUL LAZZARO, TRUSTEE OF CONTINENTAL INVESTMENT CORPORATION, IN SUPPORT OF PETITION FOR CERTIORARI

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In the
Supreme Court of the United States

OCTOBER TERM, 1981

No. 82-106

GLEN CORPORATION, et al.,
PETITIONERS,

v.

O.C. ASSOCIATES, et al.,
RESPONDENTS.

MEMORANDUM OF PAUL LAZZARO, TRUSTEE OF CONTINENTAL INVESTMENT CORPORATION, IN SUPPORT OF PETITION FOR CERTIORARI

Paul Lazzaro, the Trustee in Reorganization (the "Trustee") of Continental Investment Corporation ("CIC"),[1] respectfully submits this memorandum in support of the petition of Glen Corporation, Monte J. Wallace, Neil W. Wallace and the Minority Stockholders' Committee of Continental Investment Corporation (collectively, the "Stockholders") for a writ of

[1] The Trustee was a party to the proceedings below and submits this memorandum under Rule 19.6 of the Rules of the Supreme Court of the United States. Pursuant to the Trustee's plan of reorganization, all the outstanding common stock of CIC was sold to Liberty National Insurance Holding Company, and the stock of CIC's wholly-owned subsidiary, Con-Vest Energy Corporation, was then resold to the Trustee and distributed to CIC's former shareholders. Paul Lazzaro is also the Trustee in Reorganization of Continental Mortgage Investors, No. 76-593-S (D. Mass.).

certiorari to the United States Court of Appeals for the First Circuit to review that court's judgment of April 30, 1982, in *O.C. Associates* v. *Continental Investment Corp.*, No. 81-1743; *Debentureholders Protective Comm. of Continental Investment Corp.* v. *Continental Investment Corp.*, No. 81-1741; and *Bankers Trust Co., Indenture Trustee* v. *Continental Investment Corp.*, No. 81-1756.

Reasons for Granting the Writ

I. The Court Of Appeals' Decision Is Contrary To Decisions Of This Court, Conflicts With Decisions Of The United States Court Of Appeals For The Second Circuit, And Improperly Interferes With The Laws Of The States.

The Trustee concurs with the Stockholders that, for the reasons stated in the Petition For A Writ Of Certiorari, certiorari should be granted to review the judgment of the court of appeals.

II. Notwithstanding The Repeal Of The Bankruptcy Act, The Court Of Appeals' Decision Will Have A Substantial Impact On The Rights Of Creditors And Stockholders.

The Bankruptcy Act was repealed by the Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549. However, Section 403 of the Reform Act, 11 U.S.C. prec. § 101 (Supp. II 1978), provides that proceedings pending at its effective date continue to be governed by the Bankruptcy Act. While the number of such cases can only decrease, the effect of the court of appeals' decision, should it be permitted to stand, on the rights of creditors and, in particular, on the rights of shareholders of even a dwindling number of debtors under-

going reorganization under the Bankruptcy Act will be substantial.

The application of the court of appeals' decision in the CIC proceeding means a significant reduction in the cash available for distribution to holders of CIC's common stock.[2] The results of the application of the court of appeals' decision in another Chapter X reorganization pending in the First Circuit, that of Continental Mortgage Investors, No. 76-593-S (D. Mass.) ("CMI"), will be devastating.

On July 15, 1982, the United States District Court for the District of Massachusetts (Skinner, J.) issued its Memorandum and Order on Revised Reorganization Plans in the Chapter X reorganization of CMI.[3] Therein, the district court held that the court of appeals' decision is binding in the CMI proceeding and requires that holders of CMI's notes and debentures receive interest on the principal amount of their claims at the "legal" rate of 8% provided in the court of appeals' decision, rather than the rates of 5% and 6¼% provided in their contracts.[4]

The reorganization value found for CMI by the district court is sufficient to permit shareholder participation in the estate if debentureholders' claims are limited to contract-rate interest. The increase in interest on principal to the "legal" rate, compounded by the allowance of interest on the increased interest,[5] results in complete exclusion of some 25,000

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[2] Distributions to stockholders would be reduced by approximately $7 million, from an initially-estimated distribution of approximately $46 million. *See* Court of Appeals' Joint Appendix at 430.

[3] This order is not officially reported and appears as Appendix A to this Memorandum.

[4] The district court imposed this result without finding that the contractual provisions for the payment of interest on principal were invalid. Indeed, no argument had been raised by any party to the CMI proceeding that these provisions were unenforceable under state law.

[5] The district court also applied the court of appeals' decision to require the payment of post-petition interest on post-petition (but not pre-petition) interest on principal.

shareholders. CMI shareholders will lose more than simply the dollar amount of this increase. The CMI Trustee's plan provided for distributions of common stock in the reorganized company to CMI's current shareholders, thereby providing to the current shareholders the potential for increased value if the reorganized company were to prosper or to achieve successful results in pending litigation.

III. The Questions Presented By The Court Of Appeals' Decision Will Continue To Be Relevant Under The New Bankruptcy Code.

While § 502(b)(2) of the Bankruptcy Code, 11 U.S.C. § 502(b)(2) (Supp. III 1979), provides that a claim for "unmatured interest" shall not be allowed, a leading commentator has suggested that this provision must be read as "one of policy and convenience rather than a statement of substantive law." 3 Collier on Bankruptcy ¶502.02 at 502-33 (15th ed. 1982).

> This is primarily a technical policy device to cope in the most convenient, equitable, and economical way with the debtor's insolvency...
>
> It is true that in some cases the estate is sufficient to care for interest accrued after the filing date and in this situation it would seem inappropriate to return to the debtor a surplus of his assets after accommodation of all claims without a distribution to the creditors of accrued interest to the date of payment by the trustee. In short, a caveat to the general rule announced by section 502(b)(2) is that a debtor should pay interest computed to the date of payment, a rule whose operation is merely suspended where a debtor is so hopelessly insolvent that his assets in no way can pay the total amount of a claim, *i.e.*, principal and interest prior to bankruptcy.

> The 1978 legislation continues the proposition that a debtor may be charged with interest until the creditor is paid in full where there are sufficient assets to accommodate creditors within the scheme of the statute concerning priorities and allowability of claims.

Id. at 502-32 to -33 (footnote omitted).

Support for Collier's proposition is found in Section 726(a)(5) of the Bankruptcy Code, 11 U.S.C. § 726(a)(5) (Supp. III 1979), which, in providing for the priorities in distribution upon the liquidation of a debtor, requires the payment of interest "at the legal rate from the date of the filing of the petition" before any surplus of liquidation proceeds is returned to the debtor. In addition, the general rule applicable to the proceedings under Chapter X of the Bankruptcy Act that creditors of a solvent debtor receive interest on their claims has also been found logically applicable to reorganization proceedings under Chapter 11 of the Bankruptcy Code. *In re Oahu Cabinets, Ltd.*, 12 Bankr. 160, 163 (Bankr. D. Hawaii 1981).

Thus, the difficulties posed by the court of appeals' decision, in particular its holding that a rule of federal bankruptcy law overrides applicable state law recognizing or invalidating contractual commitments for the payment of interest, will continue to affect proceedings under the bankruptcy statutes.

IV. The Issues Presented Herein May Be Addressed Summarily By This Court.

The questions presented in the Petition For A Writ Of Certiorari involve the application of established principles of law, well developed in the decisions of this Court and the various courts of appeals. The Trustee respectfully suggests that oral argument is unnecessary and that this matter is appropriate for summary disposition by the Court.

Conclusion

For the reasons stated above, as well as those set forth in the Petition For A Writ Of Certiorari, the Trustee in Reorganization of Continental Investment Corporation respectfully submits that certiorari should be granted to review the decision of the court of appeals.

Respectfully submitted,

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August 7, 1982

APPENDIX A

UNITED STATES DISTRICT COURT
DISTRICT OF MASSACHUSETTS

In Proceedings for the
Reorganization of a
Corporation
No. 76-593-S

In Re

CONTINENTAL MORTGAGE INVESTORS,
DEBTOR

MEMORANDUM AND ORDER ON REVISED REORGANIZATION PLANS

July 15, 1982

SKINNER, D.J.

Hearings on the approval of a reorganization plan for Continental Mortgage Investors ("CMI") commenced on October 5, 1981, and continued for seven hearing days through October 16, 1981.

Following the October plan hearings, the court on December 18, 1981, entered an order ("the Order") finding the reorganization value of CMI, finding two of the reorganization plans before it not "worthy of consideration", and denying its approval to the other two filed plans. Order at 3-4, 7, 10. The parties were invited to submit substitute plans and the court made certain suggestions for plan provisions. Order at 10-11.

Further plans were submitted by the reorganization Trustee and Debentureholders' Committee B and a plan was submitted by Spartan Manufacturing Corporation ("Spartan").

Continued hearings were held on the plans on April 5, 7, 22 and 23, 1982. Among the witnesses were experts in investment banking, Tr. 3 to 62, 3-172 to 3-213, 3-214 to 3-238, 4-15 to

4-69, 4-154 to 4-156. The court also heard personal testimony from persons with a financial stake in the outcome of these proceedings. Tr. 4-73 to 4-145; Tr. 4-158 to 4-190.

Evidence was introduced to support the Trustee's plan and that of Spartan. Committee B presented no evidence in support of its own plans but stated that it might support the Spartan plan if Spartan could secure the necessary financing and if their investment bankers indicated that the Spartan plan were feasible. Tr. 21. On the last day of the hearing, Committee B stated that it was "still of an open mind" regarding the Spartan plan. Tr. 4-71.

The reorganization and liquidation values of CMI were determined in my Order of December 18, 1981. Clearly such valuations fluctuate with market conditions, but in a continuing proceeding, considerations of time forbid a rehearing on valuation at each step. I assume the valuations of December, 1981, to be still valid within a reasonable range of error, despite the current depression in real estate sales. Sales on Hawaii Loa Ridge ("the Ridge") have continued through the spring of 1982, though at less than the projected rate.

Committee B's Plan

Committee B's substitute plan bears a superficial resemblance to my suggestion contained in the Order.[1] Debentureholders are afforded an option of taking cash in the amount of 105% of the amount of their principal claims or stock in a reorganized CMI. The "New Trustees" of the reorganized company, however, would then be obliged to effect a sale of the entire Ridge as soon as practicable. In effect, this plan effects liquidation, which Committee B has been promoting throughout most of this case. The prospect of the proposed new corporation is for a short, bleak and un-

[1] There was expert testimony during the April hearing that my suggestion could not be effectuated in the present market without triggering a run on CMI's cash that would leave the resulting company unable to survive. I accept this testimony as being accurate and withdraw my suggestion.

profitable life. Any prudent debentureholder would take the cash options. Since 105% of the principal amount of the debentures far exceeds CMI's available cash, a distress sale of the Ridge would be required. For reasons stated in the Order, I do not consider this plan any more fair and equitable than Committee B's previous plan.

Spartan's Plan

The new entry is the plan offered by Spartan. Spartan's plan calls for the creation of a holding company of which each of Spartan Manufacturing Corporation and CMI is to be a subsidiary. Spartan Plan at 1. Distributions of securities under the plan are to be in securities of the holding company. *Id.* The plan provides that each creditor's claim will be satisfied by the issuance of stock and warrants and that a creditor may then choose to surrender the stock and warrants it receives for a pro-rata share of a $27 million cash fund plus, if surrendered securities exceed a certain level, a pro-rata share of 51% of the outstanding stock. *Id.* at 15-16. If surrendered securities stay below the threshold, each surrendering creditor will receive $1,050 cash in respect of each $1,000 principal of his claim (and nothing in respect of his interest claim, if any). *Id.* Shareholders' interests will be satisfied by the issuance of stock constituting 2% of the outstanding stock (if the debentureholder-surrender threshold is exceeded) or 4% thereof (if the threshold is not exceeded). *Id.* at 17.

Spartan's management refers to it as a "highly leveraged" company. In plain language, its assets exceed its debts by a very thin margin. Its 1981 debt/equity ratio was 8.4 to 1. Its debt service charges are currently $6 million a year. Over $50 million in debt is scheduled to mature before fiscal 1987. While its lines of credit have been renewed regularly up to now, failure of continuing renewal would put the company under. After payment of mandatory preferred stock dividends, Spartan shows no earnings applicable to common stock. The market price of its common stock has dropped from $3.50 per

share in October, 1981 to $1.25 per share in April, 1982. The aggregate market value of Spartan stock is only two-thirds of the value of the cash which CMI would bring to the venture. CMI security holders would own 55% of the combined corporation, but it would be managed by the Spartan board of directors, who enjoy an entrenched position under a Spartan by-law which would be carried over to the new company.

Spartan proposes to finance the cash pay-out to CMI debentureholders and provide for working capital as follows:

$7 million of CMI's cash,
$5 million of Spartan cash,
$30 million loan from a financial institution.

The entire plan is dependent upon securing the $30 million loan. The First National Bank of Boston has agreed to provide financing in the initial amount of $20 million on the following terms, *inter alia:*

(a) The first Hawaiian Bank must agree to a $10 million participation;
(b) The interest rate will be prime plus 2%;
(c) The bank will be paid an annual management fee of $200,000 regardless of the amount outstanding on the loan;
(d) The bank will share in the gross proceeds of lot sales, whether or not the loan has been repaid, in shares ranging up to 16% of gross sales proceeds and a maximum of $15,000,000, with a minimum annual payment of $500,000 even if no lots are sold;
(e) The loan will be secured by a first mortgage on Hawaii Loa Ridge and a pledge of all accounts receivable from lot sales;
(f) A bank-approved joint venture partner will be expected to contribute $500,000 and will receive 5% of gross sales. FNBB May Letter at 1-3.

The initial amount of the loan is a maximum of $20 million, with a "possibility of the loan rising to $30,000,000 depending on the valuation and availability of collateral".

Spartan believes that it is doubtful that either of the persons being considered as a joint venture partner would be willing to make a substantial cash investment in the venture. Tr. 3-78.

I find that the Spartan plan is neither fair nor equitable in that the outstanding debts of Spartan plus the proposed additional financing will leave CMI security holders with, in the most likely case, the prospect of another bankruptcy and, at best, the expectation of sharing in the hole after The First National Bank of Boston has eaten most of the doughnut. In fact, given the conditional nature of the bank's commitment, it is doubtful if the plan is even feasible.

Trustee's Plan

The Trustee's substitute plan is basically the same as its original plan, making an adjustment in stockholders' shares in the reorganized company to reflect the reorganization valuation contained in the Order.

My previous objection to the Trustee's plan, as stated in the Order, was the fact that investors were locked into a future investment of an uncertain nature without a financially viable escape. I was skeptical of Mr. Eisenberg's opinion that the reorganized company's build-up of assets would be reflected in the market price of stock.[2] That opinion has received persuasive inferential support in the new hearings in the testimony by Mr. Rosenthal, a speculator in "deep discount" bonds. ("We don't call it junk any more." T. 4-103, 104).

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[2] One additional new fact that emerged in the 1982 hearings was that all of the debentureholders who have been represented in this case bought their debentures at a small fraction of par. The most vociferous opponent of the Trustee's plan could recover his investment four or five times at the *present* market. While this has no legal significance, it does affect the weight I will give to his testimony.

It is unnecessary for me to decide if there will be sufficient protection in the marketplace for the shareholders in the reorganized company, however, since the Trustee's plan does not pass muster under a recent decision of our Court of Appeals. In *Debentureholders Protective Committee of C.I.C.* v. *C.I.C.*, __ F.2d __ (1st Cir., April 30, 1982), the Court held that in a case in pertinent respects on all fours with this one, the debentureholders are entitled to interest on unpaid post-petition interest as a matter of federal law. This is true even though the state law governing the rights of debentureholders (New York, in both cases) prohibits interest on interest. The state law was held to bar interest on pre-petition interest but not interest on post-petition interest. The court left open the question whether debentureholders could be required to accept a financially equivalent substitute, but held that mere acceleration of the time of payment was no more than the debentureholders were due under the terms of their debenture and was not a financially equivalent substitute in any case.

In addition to interest on post-petition interest, the *C.I.C.* opinion states flatly that interest on post-petition instalments of principal is to be allowed at the general legal rate of 8% rather than the contract rate. Presumably, it is still an open question as to whether a financially equivalent substitute may also be forced upon the debentureholders in lieu of this augmented interest. The Trustee argues that the rate of interest on instalments of principal was not at issue in *C.I.C.* (wherein he also served as Trustee) so that the Court's statement is *dictum*, and at variance with decisions in other circuits. I find the Court's conclusion surprising, but there it stands in black and white as a statement of the law of this Circuit, *dictum* or not, and I cannot ignore it. There may indeed be some justice in giving the holders of defaulted notes at least as good interest as other general unsecured creditors.

The Trustee and Committee B calculate the results of these strictures somewhat differently. The difference is unimportant

because in either case the debentureholders will share the entire estate and the shareholders will be excluded, since the debentureholders' claims exceed the reorganization value of CMI.

In an effort to preserve something for the shareholders notwithstanding the foregoing, the Trustee and the debtor repeat in effect the arguments made in behalf of shareholders in the first hearing, which I discussed at some length in the Order. They now concentrate on the rights the shareholders gave up to effect the Compromise with Senior Creditors, which in turn they say has increased the debentureholders' participation in the estate. Thus, according to the argument, the shareholders gave up something which permitted the debentureholders to do better in the reorganization than they otherwise would have done, and accordingly the debentureholders have already received the financial equivalent of interest on interest and interest at 8%.

One of the reasons for the Compromise, however, was the uncertainty of various claims against the Senior Creditors. As to what would have been the reorganization value of all of the assets of CMI as they existed before the Compromise, one can only speculate. Even accepting the very doubtful proposition that a benefit received other than as part of the reorganization plan itself can be accounted the financially equivalent substitute for interest on interest, I am unable to quantify the benefits accruing to the debentureholders from the Compromise with sufficient certainty to say that there is in fact financial equivalence.

Counsel for the debtor and for the Trustee correctly point out that in refusing interest on interest in the Order I recognized equities in favor of the shareholders. I am persuaded that the circumstances of the Compromise, the participation therein of debtor's counsel and the reasonable expectations of all of the parties at that time created some equities in favor of shareholders. Under the *C.I.C.* opinion, however, perceived

but inchoate equities are of no account in the face of a flat rule of law: debentureholders are entitled to interest on post-petition interest or to a financially equivalent substitute.

The net result of all of this is that the Trustee's plan must be rejected as not fair and equitable because it provides for shareholder participation without either allowing debentureholders their statutory 8% interest on post-petition instalments of principal and interest on post-petition interest or providing financially equivalent substitutes.

Accordingly, I shall further continue the plan hearing until September 20, 1982 to give the Trustee a chance to submit a further amended plan which conforms to the strictures imposed by the Court of Appeals in *C.I.C.*

So ordered.

(s) WALTER JAY SKINNER
United States District Judge

Office - Supreme Court, U.S.
FILED
AUG 25 1982
ALEXANDER L. STEVAS,
CLERK

No. 82-106

IN THE
Supreme Court of the United States
OCTOBER TERM, 1982

GLEN CORPORATION, *et al.*,
Petitioners,
v.
O.C. ASSOCIATES, *et al.*,
Respondents.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the First Circuit

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August 25, 1982

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1982

No. 82-106

GLEN CORPORATION, *et al.*,
Petitioners,

v.

O.C. ASSOCIATES, *et al.*,
Respondents.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the First Circuit

PETITIONERS' REPLY BRIEF

Respondents, though arguing the merits at length, have not cited a single precedent supporting their contention that the Bankruptcy Act creates a right to post-petition interest on a claim for unpaid interest, or on any other claim, that overrides contrary applicable state or federal nonbankruptcy law. There is no dispute that under New York law, regardless of a debtor's solvency, respondents had no right to the interest on claims for unpaid interest that the court of appeals awarded. The parties have joined issue on a single clear-cut, yet significant question of federal bankruptcy law. Petitioners respectfully suggest that this case is therefore worthy of certiorari, and even appropriate for summary reversal.

1. Respondents Cite No Authority For Their Contention Concerning The Central Issue—Whether the Bankruptcy Act Creates A Right To Interest On Claims For Unpaid Interest Where None Exists Under Applicable Nonbankruptcy Law

Respondents rely on the principle quoted in the *New Haven* case:

> "[I]f the bankrupt is solvent and there is a surplus after payment of all claims, creditors should receive interest *on their interest-bearing claims* rather than having the surplus turned over to the debtor." [1]

But under this principle, the central issue is whether the portions of respondents' claims representing unpaid interest were themselves "interest-bearing." Petitioners contend that applicable nonbankruptcy law determines whether a claim is interest-bearing; under applicable nonbankruptcy law here, the claims for unpaid interest were admittedly not interest-bearing because of governing state law.[2] Respondents contend that they were interest-bearing because something in the Bankruptcy Act made them so. Despite respondents' lengthy arguments, they do not cite one case under the Bankruptcy Act (or its predecessors or related statutes) where a court awarded interest, on a claim for unpaid interest or on any other claim, when the claim for such interest was expressly barred by applicable nonbankruptcy law.

Vanston Bondholders Protective Committee v. Green, 329 U.S. 156 (1946), the centerpiece of respondents' argument, O.C. Brief at 8-9, illustrates this precisely. The *Vanston* Court "assum[ed], *arguendo*, that the obligation for interest on interest is valid under [applicable state] law . . . ," 329 U.S. at 162, in a passage respondents ignore. The Court had no need to make any such assumption under respondents' theory that bankruptcy law alone is the source of an overriding right to post-petition interest on claims for unpaid interest. Their theory cannot survive the fact that the Court found it necessary to do so.[3]

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[1] *In re New York, New Haven & Hartford Railroad*, 4 B.R. 758, 798 (D. Conn. 1980), quoted in Brief for Respondent O.C. Associates ("O.C. Brief") at 19 (emphasis added).

[2] Both the District Court and the Court of Appeals so found. Petitioners' App. A at 14a; App. B. at 20a-21a. Respondents did not seek review of that finding.

[3] *Vanston* is thus totally at odds with respondents' contention that "state law has nothing to do with this question." O.C. Brief

To support their contention and deny any conflict among the circuits, respondents allege that the vitality of two Second Circuit cases[4] declining to award post-petition interest in bankruptcy on claims for unpaid interest where barred by state law is undermined by two later opinions of that court. O.C. Brief at 13-14; D.P.C. Brief at 9. This allegation is completely unfounded. One of the two cases, *Corbin v. Federal Reserve Bank*, 629 F.2d 233 (2d Cir. 1980), *aff'g* 475 F. Supp. 1060 (S.D.N.Y. 1979), *cert. denied*, 450 U.S. 970 (1981), had nothing to do with state law; the district court explicitly held that the claim at issue was governed by, and valid under, federal banking law.[5] Respondents contend that in the second case, *Ruskin v. Griffiths*, 269 F.2d 827 (2d Cir. 1959), *cert. denied*, 361 U.S. 947 (1960), the Second Circuit "never once mentioned the question whether the agreement [for an increased rate of interest in the event of bankruptcy] was valid under state law." O.C. Brief at 13. Not so. The Second Circuit specifically held there that the provision in question was neither a penalty nor unconscionable, citing two New York cases.[6] The First Circuit, in fact, recognized that *Ruskin* concerned the enforcement of a contractual provision *valid* under state

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at 8 (footnote omitted). State law matters whenever federal non-bankruptcy law does not. It should be clear that this case has nothing to do with whether *Vanston* would allow denial of interest on interest if respondents had a valid claim to it. Respondents' extensive discussion of this question, O.C. Brief at 8, 9, 13, 14, 16 & n.21, 19 n.25; Debentureholders Protective Committee ("D.P.C.") Brief at II, is wholly beside the point.

[4] *In re Realty Associates Securities Corp.*, 163 F.2d 387 (2d Cir.), *cert. denied*, 332 U.S. 836 (1947); *Empire Trust Co. v. Equitable Office Building Corp.*, 167 F.2d 346 (2d Cir. 1948).

[5] 475 F. Supp. at 1070. The court of appeals incorporated the district court's opinion by reference. 629 F.2d at 235.

[6] The court cited *Union Estates Co. v. Adlon Const. Co.*, 221 N.Y. 183, 116 N.E. 984 (1917) (upholding, under New York law, similar provision on same grounds), and compared it with *Newburger-Morris Co. v. Talcott*, 219 N.Y. 505, 510, 114 N.E. 846 (1916) (leading case on invalidity of contractual provision for interest on interest under New York law). 269 F.2d at 832.

law, rather than a provision, as here, that all parties concede is *invalid* under state law. Petitioners' App. A at 10a.

Every other even arguably relevant case respondents cite falls into one of the two following categories:

- The validity of a claim for an award of interest was determined under either federal nonbankruptcy law or state law.[7]
- The interest-bearing quality of the claim was unchallenged.[8]

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[7] *Ticonic National Bank v. Sprague*, 303 U.S. 406, 410 (1938) (Court found right to interest, citing two nonbankruptcy cases, before discussing whether secured creditor was entitled to receive that interest); *American Iron & Steel Mfg. Co. v. Seaboard Air Line Rwy.*, 233 U.S. 261, 264-65 (1914) (Court determined claim interest-bearing under state law) (discussed at Petition at 9-10; not cited by respondents); *In re Maryvale Community Hospital, Inc.*, 456 F.2d 410, 413-14 (9th Cir. 1972) (valid under Arizona law); *Speare v. Consolidated Assets Corp.*, 367 F.2d 208 (2d Cir. 1966) (following New Jersey usury law, claimant entitled to return of principal, but, if principal was tendered, not to any interest on principal, pre- or post-petition); *In re International Hydro-Electric System*, 101 F. Supp. 222, 223-25 (D. Mass. 1951) (valid under Massachusetts law).

[8] *Ecker v. Western Pacific R.R.*, 318 U.S. 448 (1943) (secured creditors awarded interest where contracts provided for it; senior secured creditor whose contract provided for no interest received none); *Consolidated Rock Prods. v. Du Bois*, 312 U.S. 510, 514-15 (1941); *Case v. Los Angeles Lumber Prods. Co.*, 308 U.S. 106, 109-10 (1939); *Northern Pacific Rwy. v. Boyd*, 228 U.S. 482 (1913), *aff'g* 177 F. 804, 806 (9th Cir. 1910); *Coder v. Arts*, 213 U.S. 223, 225 (1909) (brief for appellant there concedes that claim was interest-bearing); *Muskegon Motor Stockholders Protective Comm. v. Davis*, 366 F.2d 522 (6th Cir. 1966); *Palo Alto Mutual Savings & Loan Assoc. v. Williams*, 245 F.2d 77, 78-79 (9th Cir. 1957); *Eddy v. Prudence Bonds Corp.*, 165 F.2d 157, 160 (2d Cir. 1947), *cert. denied*, 333 U.S. 845 (1948); *Mortgage Loan Co. v. Livingston*, 78 F.2d 517, 518 (8th Cir.), *cert. denied*, 296 U.S. 607 (1935); *In re Imperial '400' National Inc.*, 374 F. Supp. 949, 954 (D.N.J. 1974) (SEC found New Jersey law governed award of interest where no interest rate specified in contract, 45 S.E.C. 36, 46 n.42 (1972); district court adopted SEC approach, 374 F. Supp. at 954 & n.9); *In re New York, New Haven & Hartford Railroad*, 4 B.R. 758, 770 (D. Conn. 1980).

Not one of these cases even hints that federal bankruptcy law plays any role in determining whether a claim for unpaid interest, or any other claim, is interest-bearing.[9]

The *only* exception is the instant case, which reaches the result dictated by respondents' theory, but does not accept the theory itself. Respondents contend here, as they contended below, that the absolute priority rule made the interest portion of their claims interest-bearing.[10] They cite no support for the proposition that the absolute priority rule, a rule of distribution, has ever been interpreted to create such substantive rights. Judge Wyzanski below, in fact, used the absolute priority rule only after determining that some *other* rule of bankruptcy law made the claims interest-bearing.[11] He cited three cases to support the existence of this other "rule," *see* Petitioners' App. A at 15a. Petitioners demonstrated that none of

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[9] Respondents also cite two cases not even arguably relevant because they were decided under the Bankruptcy Code. *In re Marz*, 11 B.R. 819 (S.D. Ohio 1981), involved a valid contractual provision for interest. *In re Lum*, 1 B.R. 186 (E.D. Tenn. 1979), awarded not interest on a claim, but interest on post-confirmation installment payments. Were these cases relevant, they would not support respondents' argument.

[10] O.C. Brief at Part II; D.P.C. Brief at 5. Respondents carefully ignore the absence of support for this proposition in this Court's leading absolute priority rule cases. *See, e.g., Ecker v. Western Pacific R.R., supra*, and *Consolidated Rock Prods. v. Du Bois, supra*. *Compare* Petition at 14-15 *with* O.C. Brief at 15.

[11] Petitioners' App. A. at 16a. Respondents assert that the First Circuit's decision does not conflict with this Court's decision in *Butner v. United States*, 440 U.S. 48 (1979), because "unlike *Butner*, Congress *has* created a 'federal rule' applicable to this case: the statutory 'fair and equitable' rule for distributions. . . ," O.C. Brief at 20; see D.P.C. Brief at 7-8 (*Butner* inapposite because First Circuit merely applied absolute priority rule). Since the First Circuit did not rely on the absolute priority rule to make these claims interest-bearing, but relied instead on some other "general rule of federal bankruptcy law," the result in the case below avoids conflict with *Butner* only if this Court determines that the absolute priority rule makes claims interest-bearing; no court has ever done so.

these cases supports any such "rule," Petition at 8-10, and even respondents give them short shrift here.[12] Mystery surrounds the source of a federal bankruptcy "rule" making noninterest-bearing claims interest-bearing because there is no such rule.

Respondents apparently feel that applying clearly applicable New York law would produce an inequitable result. While they suggest, O.C. Brief at 26 n.34, that they might have done better to have sought a New York judgment, not even a New York judgment would have produced interest on installments of interest falling due after that judgment, the equivalent of the interest on post-petition interest awarded by the court below. In fact, no judgment was sought either during the eighteen months between the initial default and the filing of the petition for arrangement, or after the filing. The teaching of *Butner v. United States*, 440 U.S. 48 (1979), is that respondents should have sought relief under Bankruptcy Rule 10-601 from the automatic stay of such a state court action; they did not. Any perceived inequity results not from the operation of federal bankruptcy law but from respondents' failure to seek such relief—and, more importantly, from New York law barring interest on interest.

Respondents also make much of the fact that the debtor here proved to be solvent, and that it would be "inequitable" for a solvent debtor to receive anything until all creditors had received interest on their claims for unpaid interest. But the New York law that bars the payment of interest on unpaid interest does not distinguish between solvent and insolvent debtors, and the equity of that rule of law is within the discretion of New York to decide.

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[12] Respondents do not even mention *Littleton v. Kincaid*, 179 F.2d 848 (4th Cir.), *cert. denied*, 340 U.S. 809 (1950). *City of New York v. Saper*, 336 U.S. 328 (1949), and *United States v. Bass*, 271 F.2d 129 (9th Cir. 1959), warrant only a "*see also*" at the end of a string citation, O.C. Brief at 17.

2. The Court Of Appeals' Decision Will Have A Major Impact On Cases Under The Bankruptcy Code

Respondents argue that certiorari should not be granted because the issues have been "mooted by the new Bankruptcy Code." O.C. Brief at 23. They have not been. The First Circuit's decision could have virtually the same effect on cases arising under the new Bankruptcy Code as it already has had on cases under the Bankruptcy Act,[13] because precisely analogous issues arise. Petitioners have already discussed two examples. Petition at 28-29 and n.44. A third example shows this potential effect more directly.

A bankruptcy court under the Code will be required, under certain circumstances, to determine whether a reorganization plan is "fair and equitable."[14] This may require determining whether the plan provides a class of creditors with property equal in value to the "allowed amount" of its claim. 11 U.S.C. § 1129(b)(2). Where a claim involves an invalid indenture provision for interest

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[13] The decision of the court of appeals, in addition to its effect on the 4,000 shareholders in this case, has also adversely affected the position of 25,000 public shareholders of Continental Mortgage Investors in a case arising under the Bankruptcy Act. *See* Memorandum of Paul Lazzaro, Trustee of Continental Investment Corporation, in Support of the Petition.

[14] 11 U.S.C. § 1129(b) (Supp. IV 1980). The Court must do so when a class of claims is "impaired," *see* 11 U.S.C. § 1124, and the class dissents from the proposed plan, 11 U.S.C. § 1129(a)(8). The Code also requires that each member of a class receive not less than the amount it would receive if the debtor were liquidated. 11 U.S.C. § 1129(a)(7)(A)(ii). While the Code requires that in a liquidation creditors receive interest at the "legal rate" before the debtor receives any proceeds, 11 U.S.C. § 726(a)(5), the going concern value typically far exceeds liquidation value. *See, e.g., Muskegon Motor Stockholders Protective Comm. v. Davis, supra*, 366 F.2d at 525; *In re Hollanger*, 15 B.R. 35, 47-48 (W.D. La. 1981); 124 Cong. Rec. 32406, 34006 (1978). Thus, the requirement that creditors receive as much in a reorganization as they would in a liquidation will not itself mandate the payment of interest on creditors' claims for unpaid interest.

on unpaid interest, the court will have to determine whether the "allowed claim" for the unpaid interest is itself interest-bearing. The decision of the First Circuit is squarely on point.

CONCLUSION

For the reasons stated above and in the Petition for Certiorari, certiorari should be granted to review the judgment of the court of appeals, and, if the Court deems appropriate, the decision of the court of appeals should be summarily reversed.

Respectfully submitted,

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MOTION FILED
AUG 19 1982

NO. 82-106

IN THE
SUPREME COURT OF THE UNITED STATES
OCTOBER TERM, 1981

GLEN CORPORATION, et al.,
Petitioners,

v.

O. C. ASSOCIATES, et al.,
Respondents.

MOTION FOR LEAVE TO FILE AMICUS CURIAE BRIEF AND AMICUS CURIAE BRIEF IN SUPPORT OF PETITION TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

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NO. 82-106

IN THE
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OCTOBER TERM, 1981

GLEN CORPORATION, et al.,
Petitioners,

v.

O. C. ASSOCIATES, et al.,
Respondents.

MOTION FOR LEAVE TO FILE AMICUS CURIAE BRIEF AND AMICUS CURIAE BRIEF

Continental Mortgage Investors, Debtor (hereinafter "CMI") hereby respectfully moves for leave to file the attached amicus curiae brief in this case. The consent of the attorneys for the petitioners has been obtained. The consent of the attorneys for the respondents was requested but not received.

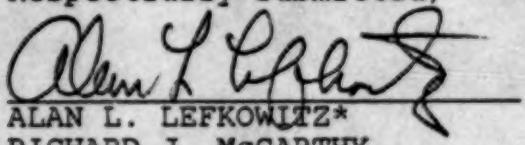
The interest of CMI in this case arises from the fact that, directly in re-

sponse to the decision of the United States Court of Appeals for the First Circuit in the instant case mandating payment to debentureholders of post-petition interest on unpaid interest as a matter of federal law, the United States District Court for the District of Massachusetts, presently conducting the CMI reorganization proceeding, reversed its prior finding and excluded 27,000 shareholders from all participation in the reorganized CMI.

The amicus curiae brief, which CMI hereby requests permission to file, illustrates, through the plight of the CMI shareholders, the immediate adverse impact of the decision of the Court of Appeals on the proper application of the absolute priority rule. In addition, the amicus curiae brief argues that the instant case will frustrate the implementation of two major reforms effected by the new Bankruptcy Code. Neither of these reforms is

discussed in the petition.

Respectfully submitted,



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IN THE
SUPREME COURT OF THE UNITED STATES
OCTOBER TERM, 1981

No. 82-106

GLEN CORPORATION, et al.,
Petitioners,

v.

O. C. ASSOCIATES, et al.,
Respondents.

STATEMENT OF
INTEREST OF CONTINENTAL
MORTGAGE INVESTORS, DEBTOR

This amicus curiae brief is filed pursuant to Supreme Court Rule 36.1. by Continental Mortgage Investors, Debtor (hereinafter, sometimes "CMI" or "Debtor"), in behalf of its approximately 27,000 public shareholders owning more than 20,000,000 outstanding shares, in support of the certiorari petition of Glen Corporation, et al. The petition seeks review of a United States Court of Appeals for the

First Circuit decision which discovered, sua sponte, a federal non-contractual right of debentureholders to post-petition interest on unpaid interest even though such interest is barred by applicable state law (New York). Directly in response to that decision, the United States District Court for the District of Massachusetts, conducting the CMI reorganization proceeding, reversed its prior finding that Debtor's shareholders were entitled to a 7% equity in a reorganized CMI and ordered the Chapter X Trustee to submit a new plan by September 20, 1982 which will exclude all such shareholder participation. If the Court of Appeals' decision is not reversed or limited, Debtor's 27,000 public shareholders will have lost their long struggle to participate in CMI's reorganization.

Debtor is a Massachusetts business trust with transferable shares which

has been in reorganization proceedings under the Bankruptcy Act of 1898 since March 8, 1976. With book value assets of $750,000,000 at the date of the filing of its Chapter XI petition, Debtor was then the third largest reorganization proceeding in the history of the United States. Its assets consisted of over 250 separate real estate projects located principally in the so-called "sun-belt" of the continental United States and in Puerto Rico and Hawaii. Its 20,000,000 outstanding shares had been actively traded on the New York Stock Exchange.

On May 1, 1979, the United States District Court for the District of Massachusetts (the "CMI reorganization court") ordered Debtor into Chapter X and revoked the earlier reference to the Bankruptcy Judge before whom the case had been pending

and who had erroneously adjudicated Debtor bankrupt.[1] Although two Chapter X trustees then were appointed, Debtor's own trustees, duly elected by its shareholders in 1975, continued to function as a board during the Chapter X proceedings, primarily in behalf of its shareholders. No shareholder committee was ever organized.

The efforts of Debtor contributed significantly to a compromise settlement (the "Compromise"), formally approved by the CMI reorganization court in May 1980, whereby Debtor exchanged most of its properties for cancellation of more than $500,000,000 of unsecured senior creditor claims. Debtor was then left with $12,000,000 cash, valuable property in

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1 In Re Continental Mortgage Investors, 528 F.2d 872 (1st Cir. 1978).

Hawaii, and an asserted net operating loss of at least $140,000,000. The claims of its junior creditors, unsecured convertible note holders and debentureholders, aggregated $45,882,000 principal and pre-petition interest, and $17,059,000 of post-petition interest. On December 18, 1981,[2] after extensive hearings, the CMI reorganization court found Debtor's reorganization value to be $67.8 million and specifically held that

> the shareholders will participate in this reorganization only to the extent that the reorganization value of the estate exceeds the claims of creditors.

App. A, at 10a - 11a.

The CMI reorganization court recognized the equitable rights of share-

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[2] Unreported Memorandum Opinion which appears in Appendix A hereto.

holders to participate in a reorganized company, and so provided by (i) limiting post-petition interest on notes and debentures to pre-petition contract rates and (ii) specifically disallowing any interest on interest. All of the CMI convertible notes and debentures provide that the rights of the holders thereof are governed by the laws of the State of New York.

Translated into numbers, the decision meant that Debtor's shareholders were to have an equity in excess of $4 million (being the excess of reorganization value of $67,800,000 over principal and interest of $62,900,000 owed to note and debentureholders) or just over 7% of the reorganized company. The first reorganization plan filed by the Chapter X Trustee, which was supported by the Debtor, specifically recognized this shareholder equity.

The Trustee's plan was also supported by at least a majority in amount of all debentureholders who thereby acknowledged existing shareholder equity.

While the CMI reorganization court rejected all of the proposed plans because none adequately provided for a "cash-out" option for those debentureholders who didn't wish to participate in the reorganized company, it continued to recognize shareholder participation under any plan, saying

> the shareholders' share [is to be] calculated on the basis of the excess of the value which I have placed on the estate over debts, post-petition interest to be limited to the pre-default rate, without interest on interest.

App. A, at 20a-21a.

New plans were submitted and additional hearings thereon were conducted

during April 1982. On April 30, the United States Court of Appeals for the First Circuit issued its opinion. On July 15,[3] the CMI reorganization court, finding that it was bound by a decision "in a case [i.e., the instant case] in pertinent respects on all fours with this one", declared that CMI debentureholders "are entitled to interest on unpaid post-petition interest as a matter of federal law", App. B, at 12b, and "excluded" Debtor's shareholders from the reorganized company "since debentureholders' claims exceed the reorganization value of CMI". App. B, at 14b.

REASONS FOR GRANTING THE WRIT

Debtor adopts and supports the arguments made by petitioners in their

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3 Unreported Memorandum Opinion which appears in Appendix B hereto.

brief to this Court. Debtor contends, in addition, that the decision of the United States Court of Appeals for the First Circuit should be reviewed because of (i) its direct effect upon one of the fundamental legal principles of reorganization carefully developed by this Court, namely, the rule of absolute priority, and (ii) it will frustrate implementation of two major reforms of the new Bankruptcy Code.

I. THE COURT OF APPEALS' DECISION DIRECTLY INTERFERES WITH PROPER APPLICATION OF THE ABSOLUTE PRIORITY RULE.

The absolute priority rule is derived from the requirement of Section 221(2) of the former Bankruptcy Act[4] (the

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[4] 11 U.S.C. §621(2). The Bankruptcy Act was repealed, effective October 1, 1979, but cases commenced prior thereto remain subject to its provisions.

"Act") that the "judge shall confirm a plan if satisfied that ... (2) the plan is fair and equitable..." The fair and equitable language has been carried over into Section 1129(b)(1) of the new Bankruptcy Code[5] (the "Code"). The Code section permits the court to "cram down" a plan over objections of creditors if, among other things,

> the plan does not discriminate unfairly, and is fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan.

The legislative history of the Code makes clear that the absolute priority rule under the Act continues to be operative under the Code.

> The general principle of the subsection [i.e., §1129(b)(1)] permits confirmation notwithstanding nonacceptance by an impaired

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5 The provisions of the Bankruptcy Code are applicable to all cases commenced on and after October 1, 1979.

> class if that class and all below it in priority are treated according to the absolute priority rule.

H. R. REP. No. 595, 95th Cong., 1st Sess. 413 (1977).

Since Consolidated Rock Products Co. v. Du Bois, 312 U.S. 510 (1941) this Court has continually recognized that the absolute priority rule provides a reorganization court with flexibility to structure a fair and equitable plan by assigning value to new securities other than by precise financial computations.

> But whether in case of a solvent company the creditors should be made whole for the change in or loss of their seniority by an increased participation in assets, in earnings or in control, or in any combination thereof, will be dependent on the facts and requirements of each case. So long as new securities offered are of a value equal to the creditors' claims, the appropriateness of the formula employed rests in the informed discretion of the Court.

Consolidated Rock Products Co., supra, at 529-30 [emphasis added].

In Group of Institutional Investors v. Chicago, M., St., P. & P.R. Co., 318 U.S. 523, 565 (1943) this Court reiterated the flexibility of the rule:

> It is sufficient that each security holder in the order of his priority receive from that which is available for the satisfaction of his claim the equitable equivalent of the rights surrendered.

The decision of the Court of Appeals, however, has compelled the CMI reorganization court to abandon the flexibility of the absolute priority rule and thereby forced it to extinguish equities which it had determined in favor of Debtor's shareholders. The decision is understandable in view of the confusion created by the Court of Appeals' acknowledged refusal to relate its decision to the rule of absolute priority. In that part of its opinion discussing the new federal noncontractual right to post-petition interest

on interest, the Court of Appeals specifically refers to the established priority rules of Chapter X but fails to explain how post-petition interest on interest is to be accomodated within them.

> We need not decide whether with respect to such a non-contractual right it would be fair and equitable and within the district court's power ... to require a straight debentureholder to take a financially equivalent substitute in exchange for his right to post-petition interest on interest, against the will of the debentureholder and solely to benefit stockholders. Nor need we consider whether to compel such a deprivation of the non-contractual right to interest on interest violates the "absolute priority" rule. See 6 Collier on Bankruptcy ¶9.08 at 1583 (14th ed., 1978).

Petitioner's App. Ex. A, at 16a.

To permit unsecured debentureholders to receive post-petition interest on interest for which they never bargained and which is illegal under state law so as to

exclude shareholders from a reorganized company to which a court has found them to be equitably entitled is a perversion of the rule of absolute priority, whether under the Act or the Code. Debentureholders, as in the case of CMI, even without post-petition interest, often receive greater value as a result of acceleration of principal obligations in bankruptcy than the present investment value of their debentures.[6] In utility cases, this Court has held that senior security holders should be compensated for the "investment value" of their contracts in the continuing enterprize, and not for rights arising on default. See, Niagara Hudson Corp. v. Levintritt, 340 U.S. 336 (1951); SEC v.

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6 The CMI notes and debentures, in the absence of default, would have come due in 1989 and 1990.

Central Illinois Securities Corp., 338 U.S. 96 (1949); Otis Co. v. SEC, 323 U.S. 624 (1945).

The rule of absolute priority requires no more than that the securities distributed to the CMI debentureholders equal, but certainly not exceed, the quality of the securities surrendered under the reorganization plan. See, Billyou, Priority Rights of Security Holders in Bankruptcy Reorganization, 67 HARV. L. REV. 553 (1954); Blum, Full Priority and Full Compensation in Corporate Reorganization, 25 U. CHI. L. REV. 417 (1958). Section 1129 (b)(2) of the Bankruptcy Code codifies the rule.[7] By awarding post-petition interest

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[7] Section 1129(b)(1) provides, in part, that "the court...shall confirm the plan...if the plan does not discriminate unfairly, and is fair and equitable with respect to each class of claims or interests that is impaired under, and has not accepted, the plan."

on interest debentureholders are likely to receive a windfall occasioned solely by bankruptcy. See, Bonbright and Bergman, Two Rival Theories of Priority Rights of Security Holders in a Corporate Reorganization, 28 COLUM. L. REV. 127 (1928).

We need not speculate as to whether the right to obtain such a windfall has now been established for future cases. It is about to happen to CMI debentureholders as a direct result of the Court of Appeals' decision. The CMI reorganization court regards that decision as "a flat rule of law" which does not permit it to take into account some "equities in favor of shareholders", as does the rule of absolute priority. App. B, at 16b. Moreover, under the Court of Appeals' "financial equivalence" test, the CMI reorganization court believes it must be able "to quantify"

non-monetary benefits accruing to debentureholders as a result of the Compromise with senior creditors in order to find that such benefits compensate debentureholders for lost interest on post-petition interest. This the CMI reorganization court is unable to do. App. B, at 15b. Nor, we suggest, could any other court make such a financial determination with any reasonable degree of certainty.

II. THE COURT OF APPEALS' DECISION WILL FRUSTRATE IMPLEMENTATION OF TWO MAJOR REFORMS EFFECTED BY THE NEW CODE.

The Court of Appeals' refusal to deal with the absolute priority rule will cause parties to resort frequently to the complex valuation procedures of Section 1129(b)(1) and (2) of the Code and require obtaining of formal consents to Chapter 11 plans, which is precisely what the Code

draftsmen sought to avoid. One major Code reform is to expedite confirmation of Chapter 11 plans by avoiding the lengthy and expensive valuation hearings which were required prior to formulation of a Chapter X plan under the old Act. Thus, if CMI had not conveyed most of its properties in cancellation of its senior debt, its reorganization could have involved valuations of 250 separate properties by the reorganization court. Under the Code, however, no Chapter 11 valuation hearing is required unless there is formal objection by a class of creditors or the rights of any class are impaired and such class objects.

Another major Code reform is to reduce the expensive need for obtaining formal consents from each class of claim or interest to a plan. Hence, a court is required to confirm a plan if it meets certain basic

requirements set forth in Section 1129(a) and

> with respect to each class -
>
> (A) such class has accepted the plan; or
> (B) such class is not impaired under the plan.

Section 1129(a)(8).

If a class is unimpaired, its acceptance of the plan is assumed.[8]

Impairment of a class of claims or interests occurs unless,

> with respect to each claim or interest of such class, the plan (1) leaves unaltered the legal, equitable and contractual rights to which such claim or interest entitles the holder of such claim or interest....

Section 1124.

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8 Section 1126(f) provides that: "Notwithstanding any other provision of this section, a class that is not impaired under a plan is deemed to have accepted the plan, and solicitation of acceptance with respect to such class from the holders of claims or interest of such class is not required."

As a result of the Court of Appeals' decision, if a Chapter 11 plan fails to recognize post-petition interest on interest because it is illegal under applicable state law, debtholders will deem their rights impaired under Section 1124(1) and will be able to force valuation hearings to obtain what in many instances will result in a windfall for them. If, on the other hand, a Chapter 11 plan awards such interest, creditors junior to debtholders and stockholders are likely to deem their contractual and equitable rights impaired by the windfall and be able to force valuation hearings. In either event, the Code provisions for expeditious confirmation of reorganization plans will have been lost and the increased expense to the estate of valuation hearings and the possible need

for obtaining formal consents will be significant.[9]

Had the Court of Appeals' decision focused upon the relationship between the rule of absolute priority and the federal non-contractual right to post-petition interest on interest, the dilemma might possibly have been avoided. A reorganization court might have been furnished with a rule as to when and to what extent, if any, a windfall from post-petition interest on interest could, consistent with the rule of absolute priority, be permitted without interfering with the equitable interests of junior creditors and stockholders. Standing as it does, the decision deprives parties of their contractual or equitable rights, produces windfalls for creditors,

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9 See, 5 Collier on Bankruptcy ¶1124.03 at 1124-11 (15th ed. 1979).

and increases the expense and burden of administration of estates.

CONCLUSION

For the reasons stated above, certiorari should be granted to review the judgment of the United States Court of Appeals for the First Circuit.

Respectfully submitted,

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August 16, 1982

APPENDIX A

UNITED STATES DISTRICT COURT
DISTRICT OF MASSACHUSETTS

In Re	*	In Proceedings
CONTINENTAL MORTGAGE INVESTORS,	*	for the Reorganization
	*	of a Corporation
Debtor	*	
	*	No. 76-593-S

MEMORANDUM AND ORDER ON
PROPOSED REORGANIZATION PLANS

December 18, 1981

SKINNER, D.J.

This former Real Estate Investment Trust ("REIT") petitioned for reorganization under Chapter XI in March of 1976. The petition was referred to a bankruptcy judge, before whom the various creditors contended without result until May 1, 1979, when I revoked the reference and ordered the company into Chapter X reorganization as an alternative to liquidation. In May

of 1980, this court approved a compromise between the senior debtholders, the subordinated debtholders (hereinafter the debenture holders), and the Chapter X Trustees. As a result, the senior debtor received all of the debtor's real estate holdings except Hawaii Loa Ridge ("the Ridge"). Various adjustments of cash and liabilities were made (and have been readjusted since) which in a general way leave the debtor (in addition to the Ridge) about $12 million in cash, claims against some of its former officers, some liabilities not related to assets conveyed to the senior creditors, and an asserted net operating loss carryforward of $140 million. The claims of the debenture holders total $45,882,000 principal and pre-petition interest, with an asserted claim of $17,059,000 in post-petition interest[1] to September 30, 1981. The

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[1] At pre-default rates, and without interest on interest.

debenture holders are represented by two groups, Committee A and Committee B. There are approximately $3 million of other pre-petition and administrative claims.

There is presently outstanding an offer to the trustee from Nu-West Corporation to buy Hawaii Loa Ridge for $33 million cash.

A. The Plans.

Four plans have been filed:

1. The Trustee's plan provides for a single class of stock in which the shareholders participate at 7.5% with an option to purchase one additional share for each share distributed at twice the per share reorganization value. The scenario implicit in the Trustee's plan calls for the development and sale of Hawaii Loa Ridge with profits therefrom to be tax-sheltered by the net operating loss carry-forward (the NOL). The cash is then to be rein-

vested in a new business enterprise, probably unrelated to real estate investment.

2. John Hancock Mutual Life Insurance Company, the holder of senior debt and debentures has filed a plan which differs from the Trustee's in the following respects: Debenture holders shall have the option to choose between interest bearing notes and shares having a reorganization value of 115% of their allowed claims, provided that the amount of notes does not exceed $30 million and provided further that interest shall be payable only to the extent of income; shareholders shall receive one share in the new corporation for each share of CMI; and development and sale of Hawaii Loa Ridge must be completed by June 30, 1988.

3. Mary Mayer, a stockholder, has filed a plan, the salient distinguishable feature of which is that it calls for the shareholders to participate with the deben-

ture holders on a 50-50 basis.

4. Committee B has filed a plan calling for the immediate disposition of Hawaii Loa Ridge and the liquidation of CMI. By their calculation this would permit debenture holders to receive 105% of their principal. Shareholders would receive nothing. Committee has also filed a motion for an order directing the Trustee to accept the offer of Nu-West to buy Hawaii Loa Ridge for $33 million.

Committee A and the Eisenberg-Whitman group of debenture holders support the Trustee's plan.

The debtor generally supports the Trustee's plan but urges greater participation for the shareholders.

B. Plans Worthy of Consideration (Bankruptcy Act, §169, Rule 10-303).

I find all of the plans worthy of consideration except the plan offered by Mrs.

Mayer, which so grievously distorts the absolute priority rule as to be unworthy of consideration, and the John Hancock Plan, discussed below.

In any case, I have been informed by the Securities and Exchange Commission that its staff will not review any plans or advise me with reference to them because of budgetary restrictions. Accordingly, I shall proceed directly to consideration of their fairness, equity and feasibility, Bankruptcy Act, §216.

C. Consideration of the John Hancock Plan.

The John Hancock Plan calls for a substantial part of the recapitalization of the reorganized company to be in the form of debt, up to $30 million, albeit with relatively non-onerous interest provisions. The problem with it is that not a single one of the financial experts who testified in the hearings supported such a plan as

being in the best interest of the estate. All were unanimous in condemning such a plan as imposing an unnecessary burden on the reorganized company. Accordingly, I find that the proposed John Hancock plan is not worthy of consideration, and by extension not fair, equitable and feasible.

D. Consideration of Shareholders' Rights.

Ordinarily a reorganization plan must recognize the absolute priorities of different classes of claimants. The shareholders are at the bottom of the ladder, and participate only to the extent that available assets exceed the provable claims of creditors.

The Trustee, however, suggests several alternative reasons to permit the shareholders a 7-½% interest in the reorganized company:

1. Because of potential fraud claims by shareholders against

the corporation, their participation should be permitted as a form of compromise of their claims as creditors.

2. The compromise of the claims of senior creditors included an understanding of all parties, including the debenture holders, that the shareholders would have a substantial interest in the reorganized corporation in return for giving up equitable subordination claims against the senior creditors.

The debtor supports these views and adds the following reason for stockholder participation:

Since the senior creditors received only 84% of their principal claims, it would be a violation of the principle of absolute priority to permit the deb-

enture holders to receive a greater percentage of their claims. The shareholder would be entitled to the remainder of the estate.

I reject all of these theories. For the court to elevate the rights of shareholders as a part of a compromise of claims there have to be viable claims to compromise. Some shareholders may indeed have once had a claim against the estate for fraudulent representations which induced them to buy their shares. Several shareholders' class actions against CMI were, in fact, filed. No claims have been filed in these proceedings, however, and the time for filing is past. As a result, the class actions are dead and the shareholders' claims are no longer viable. The Trustee suggests that I could extend the time for filing, which is within the court's discretion. To revive a claim so that I can

compromise it, however, strikes me as bald manipulation rather than creative use of the court's equitable power.

The compromise agreement with the senior creditors which I approved contained no assurance to the shareholders that they would participate in the eventual reorganization. As I viewed, and view, that arrangement, what the shareholders bargained for was a chance to participate, which they would not have had if the senior creditors had been successful in maintaining their claims in full.

The debtors' theory in untenable. The senior creditors waived their priority claims in order to obtain a relatively fast bailout. Their percentage of recovery has no bearing on the remaining aspects of the reorganization.

Accordingly, the shareholders will participate in this reorganization only to the extent that the reorganization value of

the estate exceeds the claims of creditors. The shareholders have some equitable claim for consideration, but that claim is amply satisfied by holding post-petition interest on the debentures to pre-default rates rather than the stepped-up post-default rates provided by the terms of the debentures, and by disallowing interest on interest.

E. The NOL.

Critical both to valuation for reorganization purposes and the feasibility of the Trustee's plan is the viability of the NOL. The Trustee's certified public accountant has testified that there is a cumulative NOL of approximately $140 million which can be fully utilized to shelter substantial income of the reorganized company from federal income tax. The NOL is available because of special tax provisions governing REITs which permit the

carry-forward of loss from certain years 15 years into the future. The NOL is subject to audit when used. If the Internal Revenue Service conducts future audits, the reorganized company will have the burden of showing that the losses occurred in the qualifying years and that CMI qualified as a REIT during those years.

While the Trustee's witness testified that the record support for these positions will be available, Mortimer Caplin, a former Commissioner of Internal Revenue, testified that in his opinion the conduct of CMI management from 1972 through 1976 as revealed in the Trustee's own §167 Preliminary and Partial Report might result in the disqualification of a substantial part of the NOL.

It is impossible to quantify these doubts in terms of valuation, and Mr. Caplin's testimony offers no clue. I will not make any attempt to resolve the validity of

the NOL for several obvious reasons:

1. The principal adversary, the Internal Revenue Service, is not a party to these proceedings;
2. The relevant evidence has not been developed before me; and
3. This is not the forum in which the issues will be decided.

The Trustee's valuation witness suggests that the potential weakness of the NOL should be reflected by discounting future cash flow at a high rate appropriate for an increased risk. I do not find this a wholly satisfactory measure of a risk running somewhere between 0 and $140 million. Neither Committee B nor anyone else has offered any better solution, however. Committee B's suggestion that the NOL be treated as of no value has no more virtue

than the suggestion that it be treated at full value.

Accordingly, for purposes of assigning a reorganization value to the estate, I shall adopt the Trustee's suggestion of projecting future cash flow as if the NOL could be fully utilized and adopting a discount rate which presumably reflects the risk that the NOL will be to some extent disallowed.

F. Valuation.

Assuming the viability of the NOL, valuation of the proposed reorganized company is still dependent upon a number of other variables: appreciation in the value of the Ridge over the expected period of liquidation; the absorption rate (the time it will take to sell off the Ridge); the expected rate of return on reinvested proceeds of sale; and the discount rate applied to reduce the expected future cash

flow to present value. Wide ranges of choice of each of these variables are rationally supportable. Selection of particular values within those ranges must be frankly recognized as reflecting subjective evaluation. Accepting the basic postulates of the John Child appraisal of the Ridge, I have decided to apply a 15% straight line rate of appreciation, a 17% rate of return on reinvestment and an 18% discount rate. The result is a reorganization value of approximately $67.8 million.

The present liquidation value is approximately $53.8 million.

G. General Considerations.

The reorganization proposed by the Trustee is not the typical reorganization which would be proposed for a manufacturing company, a utility or a railroad, in which the reorganized company would carry on some part of the old company's former business

with a new capital structure. This company has but one noncash capital asset, Hawaii Loa Ridge, and its aim is to sell it. The choice is between immediate liquidation and gradual liquidation through the development and sale of lots.

The Trustee's plan has the following characteristics:

A. On the positive side, there is the potential utilization of the NOL to derive an entrepreneur's profit from the development of the Ridge sheltered from income tax. The capital which then might be reinvested in a new business would be formidable, enabling a wide variety of choices and providing financial strength to the new enterprise. The reorganization value which I have assigned would permit some participation by the shareholders.

B. On the negative side, the ultimate business of the enterprise is unknown, and the course of future investment will be set not by the investors but by the board of directors of the reorganized company. If the NOL is disallowed to a substantial degree, furthermore, the advantages of the plan will evaporate.

The plan proposed by Committee B has the following characteristics:

A. On the positive side, immediate realization of cash for the debenture holders and the exercise by them of their own choice of reinvestment.

B. On the negative side, the chance to realize the value of the NOL would be irrevocably abandoned. Shareholders would not participate in any respect.

H. The Possibility of Submitting Both Plans to a Vote of Creditors.

I find no clear rational criteria for choosing between these plans. The bias in Chapter X proceedings in favor of reorganization fades when the choice is in effect between two forms of liquidation and reinvestment, although a bias doubtless remains in favor of a plan which offers some return to the shareholders. Basically, the choice would be governed by one's predilection for long-term open-ended adventure with the possibility of large profits as opposed to a predilection for a quick return. For debenture holders who purchased their securities post-petition at sharply discounted prices, a return at slightly over par may be attractive.

One way to offer the investors a choice would be to submit both plans to a vote. While the Bankruptcy Act permits this course, virtually all courts and com-

mentators have rejected it as confusing to the security holders and likely to result in rejection of both plans. I agree, and reject that option.

I. Findings.

In my opinion, nevertheless, there should be some element of individual choice available beyond the two-thirds voting requirement mandated by the Bankruptcy Act. If the Trustee's plan were to receive the required number of favorable votes, the dissenters would become involuntary participants in an unidentified endeavor. While it is possible that the increased financial power of the reorganized company will be reflected in the price of its common stock, this is not necessarily so while a cloud remains over the NOL. "Opting out" through the marketplace may not be the viable choice which Mr. Eisenberg suggested in his testimony.

I find that Committee B's plan is not fair and equitable because it forecloses any chance of utilization of the NOL, a potentially valuable asset of the estate.

I find that the Trustee's plan is not fair and equitable because it provides no mechanism for a dissenting debenture holder to be released from a form of open-ended investment which he never contemplated and which no one can presently confidently evaluate for the long term.

J. Substitute Plan.

All parties shall have the opportunity to file proposed substitute plans within thirty days. Without imposing any limitation or requirements on the parties, I offer the following suggestions as to acceptable provisions:

1. A plan like the Trustee's plan, with the shareholders' share calculated on the basis of

the excess of the value which I have placed on the estate over debts, post-petition interest to be limited to the pre-default rate, without interest on interest.

2. A provision for dissident debenture holders to signify a desire to liquidate their securities within sixty days of the confirmation order. The reorganized company would then pay the principal value of their notes[2] to such former debenture holders in cash within six months of such notification, plus interest at the pre-default rate from the date of the confirmation order. If the number of liqui-

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[2] They should be entitled to no more than under present liquidation as proposed by Committee B.

dating former debenture holders was so large that such payment drew available cash below acceptable levels, the new management would be forced to decide either to liquidate or to raise the cash some other way. The forces of the marketplace will control, which in the peculiar circumstances of this situation is, in my opinion, an acceptable solution.

K. Committee B's Motion - Proposal of Spartan Manufacturing Corporation.

Committee B's motion to require the Trustee to accept the offer of Nu-West to purchase the Ridge is DENIED. Such denial shall not be deemed a limitation on the Trustee's freedom to explore offers of sale and to file a plan based thereon. In particular, I commend to the Trustee's atten-

tion exploration of the proposal described in a letter to me from Spartan Manufacturing Corporation ("Spartan"), dated December 16, 1981, a copy of which is annexed hereto. I invite Spartan to submit a plan and order that the name of Lawrence M. Powers, the chairman of Spartan's Board be added to the notice list. The Spartan offer in its present form presents some considerable difficulties, based as it is on the John Hancock Plan. The component of Spartan stock may be inadequate. The opportunity for creative negotiation is clearly present, however, and in my opinion should be pursued. It should not be pursued, however, without knowledge of a letter received today from counsel for Nu-West, a copy of which is also attached.

/s/ Walter Jay Skinner
United States District Judge

APPENDIX B

UNITED STATES DISTRICT COURT
DISTRICT OF MASSACHUSETTS

In Re	*	In Proceedings
CONTINENTAL MORTGAGE	*	for the
INVESTORS,	*	Reorganization
	*	of a Corpora-
Debtor	*	tion
	*	No. 76-593-S

MEMORANDUM AND ORDER ON
REVISED REORGANIZATION PLANS

July 15, 1982

SKINNER, D.J.

Hearings on the approval of a reorganization plan for Continental Mortgage Investors ("CMI") commenced on October 5, 1981, and continued for seven hearing days through October 16, 1981.

Following the October plan hearings, the court on December 18, 1981, entered an order ("the Order") finding the reorganization value of CMI, finding two of the re-

organization plans before it not "worthy of consideration", and denying its approval to the other two filed plans. Order at 3-4, 7, 10. The parties were invited to submit substitute plans and the court made certain suggestions for plan provisions. Order at 10-11.

Further plans were submitted by the reorganization Trustee and Debenture-holders' Committee B and a plan was submitted by Spartan Manufacturing Corporation ("Spartan").

Continued hearings were held on the plans on April 5, 7, 22 and 23, 1982. Among the witnesses were experts in investment banking, Tr. 3 to 62, 3-172 to 3-213, 3-214 to 3-238, 4-15 to 4-69, 4-154 to 4-156. The court also heard personal testimony from persons with a financial stake in the outcome of these proceedings. Tr. 4-73 to 4-145; Tr. 4-158 to 4-190.

Evidence was introduced to support the

Trustee's plan and that of Spartan. Committee B presented no evidence in support of its own plans but stated that it might support the Spartan plan if Spartan could secure the necessary financing and if their investment bankers indicated that the Spartan plan were feasible. Tr. 21. On the last day of the hearing, Committee B stated that it was "still of an open mind" regarding the Spartan plan. Tr. 4-71.

The reorganization and liquidation values of CMI were determined in my Order of December 18, 1981. Clearly such valuations fluctuate with market conditions, but in a continuing proceeding, considerations of time forbid a rehearing on valuation at each step. I assume the valuations of December, 1981, to be still valid within a reasonable range of error, despite the current depression in real estate sales. Sales on Hawaii Loa Ridge ("the Ridge") have continued through the

spring of 1982, though at less than the projected rate.

Committee B's Plan

Committee B's substitute plan bears a superficial resemblance to my suggestion contained in the Order.[1] Debentureholders are afforded an option of taking cash in the amount of 105% of the amount of their principal claims or stock in a reorganized CMI. The "New Trustees" of the reorganized company, however, would then be obliged to effect a sale of the entire Ridge as soon as practicable. In effect, this plan effects liquidation, which Committee B has been promoting throughout most of this case. The prospect of the proposed new

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[1] There was expert testimony during the April hearing that my suggestion could not be effectuated in the present market without triggering a run on CMI's cash that would leave the resulting company unable to survive. I accept this testimony as being accurate and withdraw my suggestion.

corporation is for a short, bleak and unprofitable life. Any prudent debentureholder would take the cash option. Since 105% of the principal amount of the debentures far exceeds CMI's available cash, a distress sale of the Ridge would be required. For reasons stated in the Order, I do not consider this plan any more fair and equitable than Committee B's previous plan.

Spartan's Plan

The new entry is the plan offered by Spartan. Spartan's plan calls for the creation of a holding company of which each of Spartan Manufacturing Corporation and CMI is to be a subsidiary. Spartan Plan at 1. Distributions of securities under the plan are to be in securities of the holding company. Id. The plan provides that each creditor's claim will be satisfied by the issuance of stock and warrants and that a creditor may then choose to surrender the

stock and warrants it receives for a pro-rata share of a $27 million cash fund plus, if surrendered securities exceed a certain level, a pro-rata share of 51% of the outstanding stock. Id. at 15-16. If surrendered securities stay below the threshold, each surrendering creditor will receive $1,050 cash in respect of each $1,000 principal of his claim (and nothing in respect of his interest claim, if any). Id. Shareholders' interests will be satisfied by the issuance of stock constituting 2% of the outstanding stock (if the debenture-holder-surrender threshold is exceeded) or 4% thereof (if the threshold is not exceeded). Id. at 17.

Spartan's management refers to it as a "highly leveraged" company. In plain language, its assets exceed its debts by a very thin margin. Its 1981 debt/equity ratio was 8.4 to 1. Its debt service charges are currently $6 million a year.

Over $50 million in debt is scheduled to mature before fiscal 1987. While its lines of credit have been renewed regularly up to now, failure of continuing renewal would put the company under. After payment of mandatory preferred stock dividends, Spartan shows no earnings applicable to common stock. The market price of its common stock has dropped from $3.50 per share in October, 1981 to $1.25 per share in April, 1982. The aggregate market value of Spartan stock is only two-thirds of the value of the cash which CMI would bring to the venture. CMI security holders would own 55% of the combined corporation, but it would be managed by the Spartan board of directors, who enjoy an entrenched position under a Spartan by-law which would be carried over to the new company.

Spartan proposes to finance the cash pay-out to CMI debentureholders and provide for working capital as follows:

$7 million of CMI's cash,

$5 million of Spartan cash,

$30 million loan from a financial institution.

The entire plan is dependent upon securing the $30 million loan. The First National Bank of Boston has agreed to provide financing in the initial amount of $20 million on the following terms, inter alia:

(a) The first Hawaiian Bank must agree to a $10 million participation;

(b) The interest rate will be prime plus 2%;

(c) The bank will be paid an annual management fee of $200,000 regardless of the amount outstanding on the loan;

(d) The bank will share in the gross proceeds of lot sales, whether or not the loan has been repaid, in shares ranging up to 16% of gross sales proceeds and a maximum of $15,000,000, with a minimum annual payment of $500,000 even if no lots are sold;

(e) The loan will be secured by a first mortgage on Hawaii Loa Ridge and a pledge of all accounts receivable from lot sales;

(f) A bank-approved joint venture partner will be expected to contribute $500,000 and will receive 5% of gross sales. FNBB May Letter at 1-3.

The initial amount of the loan is a maximum of $20 million, with a "possibility of the loan rising to $30,000,000 depending on the valuation and availability of collateral".

Spartan believes that it is doubtful that either of the persons being considered as a joint venture partner would be willing to make a substantial cash investment in the venture. Tr. 3-78.

I find that the Spartan plan is neither fair nor equitable in that the outstanding debts of Spartan plus the proposed additional financing will leave CMI security holders with, in the most likely case, the prospect of another bankruptcy and, at best, the expectation of sharing in the hole after The First National Bank of Boston has eaten most of the doughnut. In

fact, given the conditional nature of the bank's commitment, it is doubtful if the plan is even feasible.

Trustee's Plan

The Trustee's substitute plan is basically the same as its original plan, making an adjustment in stockholders' shares in the reorganized company to reflect the reorganization valuation contained in the Order.

My previous objection to the Trustee's plan, as stated in the Order, was the fact that investors were locked into a future investment of an uncertain nature without a financially viable escape. I was skeptical of Mr. Eisenberg's opinion that the reorganized company's build-up of assets would be reflected in the market price of

stock.[2] That opinion has received persuasive inferential support in the new hearings in the testimony by Mr. Rosenthal, a speculator in "deep discount" bonds. ("We don't call it junk any more." T. 4-103, 104).

It is unnecessary for me to decide if there will be sufficient protection in the marketplace for the shareholders in the reorganized company, however, since the Trustee's plan does not pass muster under a recent decision of our Court of Appeals. In Debentureholders Protective Committee of C.I.C. v. C.I.C., _____ F.2d _____ (1st Cir., April 30, 1982), the Court held

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2 One additional new fact that emerged in the 1982 hearings was that all of the debentureholders who have been represented in this case bought their debentures at a small fraction of par. The most vociferous opponent of the Trustee's plan could recover his investment four or five times at the present market. While this has no legal significance, it does affect the weight I will give to his testimony.

that in a case in pertinent respects on all fours with this one, the debentureholders are entitled to interest on unpaid post-petition interest as a matter of federal law. This is true even though the state law governing the rights of debentureholders (New York, in both cases) prohibits interest on interest. The state law was held to bar interest on pre-petition interest but not interest on post-petition interest. The court left open the question whether debentureholders could be required to accept a financially equivalent substitute, but held that mere acceleration of the time of payment was no more than the debentureholders were due under the terms of their debenture and was not a financially equivalent substitute in any case.

In addition to interest on post-petition interest, the C.I.C. opinion states flatly that interest on post-petition instalments of principal is to be allowed at

the general legal rate of 8% rather than the contract rate. Presumably, it is still an open question as to whether a financially equivalent substitute may also be forced upon the debentureholders in lieu of this augmented interest. The Trustee argues that the rate of interest on instalments of principal was not at issue in C.I.C. (wherein he also served as Trustee) so that the Court's statement is dictum, and at variance with decisions in other circuits. I find the Court's conclusion surprising, but there it stands in black and white as a statement of the law of this Circuit, dictum or not, and I cannot ignore it. There may indeed be some justice in giving the holders of defaulted notes at least as good interest as other general unsecured creditors.

The Trustee and Committee B calculate the results of these strictures somewhat differently. The difference is unimportant

because in either case the debentureholders will share the entire estate and the shareholders will be excluded, since the debentureholders' claims exceed the reorganization value of CMI.

In an effort to preserve something for the shareholders notwithstanding the foregoing, the Trustee and the debtor repeat in effect the arguments made in behalf of shareholders in the first hearing, which I discussed at some length in the Order. They now concentrate on the rights the shareholders gave up to effect the Compromise with Senior Creditors, which in turn they say has increased the debentureholders' participation in the estate. Thus, according to the argument, the shareholders gave up something which permitted the debentureholders to do better in the reorganization than they otherwise would have done, and accordingly the debentureholders have already received the financial equiva-

lent of interest on interest and interest at 8%.

One of the reasons for the Compromise, however, was the uncertainty of various claims against the Senior Creditors. As to what would have been the reorganization value of all of the assets of CMI as they existed before the Compromise, one can only speculate. Even accepting the very doubtful proposition that a benefit received other than as a part of the reorganization plan itself can be accounted the financially equivalent substitute for interest on interest, I am unable to quantify the benefits accruing to the debentureholders from the Compromise with sufficient certainty to say that there is in fact financial equivalence.

Counsel for the debtor and for the Trustee correctly point out that in refusing interest on interest in the Order I recognized equities in favor of the share-

holders. I am persuaded that the circumstances of the Compromise, the participation therein of debtor's counsel and the reasonable expectations of all of the parties at that time created some equities in favor of shareholders. Under the C.I.C. opinion, however, perceived but inchoate equities are of no account in the face of a flat rule of law: debentureholders are entitled to interest on post-petition interest or to a financially equivalent substitute.

The net result of all of this is that the Trustee's plan must be rejected as not fair and equitable because it provides for shareholder participation without either allowing debentureholders their statutory 8% interest on post-petition instalments of principal and interest on post-petition interest or providing financially equivalent substitutes.

Accordingly, I shall further continue the plan hearing until September 20, 1982

to give the Trustee a chance to submit a further amended plan which conforms to the strictures imposed by the Court of Appeals in C.I.C.

So ordered.

/s/ Walter Jay Skinner
United States District Judge

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